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BOOK REVIEWS

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Welfare and the Culture of Poverty

William A. Niskanen

At the dawn of the American welfare state, in his 1935 State of the Union message, President Franklin D. Roosevelt (1938: 19–20) proposed social security, unemployment insurance, and (what was then called) aid to dependent children to help the deserving poor, but he added an ominous warning:

> The lessons of history, confirmed by evidence immediately before me, show conclusively that continued dependence on relief induces a spiritual and moral disintegration fundamentally destructive to the national fiber. To dole out relief in this way is to administer a narcotic, a subtle destroyer of the human spirit. It is inimical to the dictates of sound policy. It is a violation of the traditions of America.

More than 60 years later, it should be clear that the narcotic of "continued dependence on relief" is less subtle and more destructive than Roosevelt feared.

Summary

Welfare is both a consequence and a cause of several conditions best described as social pathologies. These conditions include dependency, poverty, out-of-wedlock births, nonemployment, abortion, and violent crime.[1] The basic hypothesis of this study is that welfare dependency and the other pathologies are jointly determined and are derivative of a common set of other conditions.

Differences in the levels of these conditions among the states provide a basis for estimating the specific effects of welfare benefits, the

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[1]The sample for this study is the average level of these six conditions in the 50 states plus the District of Columbia. All data are from the *Statistical Abstract of the United States* and are for 1992 unless specially noted.

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relations among the social pathologies, and the extent to which the pathologies are based on a common set of root causes.

Analysis of the state data for 1992 yields the following estimates of the effects of an increase in Aid to Families with Dependent Children (AFDC) benefits by 1 percent of the average personal income in the state: the number of AFDC recipients would increase by about 3 percent; the number of people in poverty would increase by about 0.8 percent; the number of births to single mothers would increase by about 2.1 percent; the number of adults who are not employed would increase by about 0.5 percent; the number of abortions would increase by about 1.2 percent; and the violent crime rate would increase by about 1.1 percent.

The social pathologies associated with the current welfare system no longer seem acceptable, not so much because of their fiscal costs but because of their malign effects. An important question addressed in this study is the extent to which these pathologies are dependent on conditions that could be changed by government policy.

Social Pathologies

For this study, the six conditions are described as social pathologies, not because they are necessarily illegal or immoral in an individual case but because the level of these conditions is broadly considered as undesirable. There is less consensus, however, about the relative undesirability of these conditions. An increase in welfare dependency, for example. may be considered desirable if it reduces one or more of the other conditions. As it turns out, however, an increase in AFDC benefits increases *all* of the six pathologies that are the focus of this study.

Welfare Dependency

In 1992, 5.4 percent of the national population were dependent on cash benefits from AFDC, with a range from 2.0 percent in Idaho to 10.8 percent in the District of Columbia. This program is jointly financed by the federal and state governments and is administered by the states subject to numerous federal guidelines. All AFDC recipients are also eligible for food stamps and medicaid, and many also receive benefits from special food programs, utility assistance, and housing assistance.

An additional 2.6 percent of the population receive cash benefits from other federal and state programs, for a total of 8 percent who are dependent on cash benefits. A broader 9.9 percent of the population receive food stamps, and 11.9 percent are covered by medicaid. A

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more complex study would be necessary to estimate the causes and consequences of the broader set of means-tested programs. For this study, the level of welfare dependency is defined as the percent of the population that receive cash benefits from the AFDC program.

Poverty

A total of 14.5 percent of the population have money income below the official poverty line, with a range from 7.6 percent in Delaware to 24.5 percent in Mississippi. The national poverty rate is now about the same as when the War on Poverty was instituted 30 years ago, despite the expenditure of over $5 trillion (at 1993 prices) for means-tested public assistance programs in the intervening years and a 75 percent increase in average real income. More means-tested benefits may or may not have contributed to the incidence of poverty but they have clearly not reduced it.

Any definition of poverty, of course, is somewhat arbitrary, depending on what types of income are included. The government estimates national poverty rates for 15 different aggregations of income, taxes, and transfers, with a range from 10.4 percent based on all after-tax income and transfers to a high of 22.6 percent based only on pre-tax money income. For this study, the level of poverty is defined as the percent of the population with pre-tax money income and cash transfers below the official poverty line, the only such data available by state.

Out-of-Wedlock Births

Out-of-wedlock births are the most rapidly increasing social pathology. On a national basis (in 1991), 29.2 percent of births were to single mothers, with a range from 14.3 percent in Utah to 65.9 percent in the District of Columbia. Since 1960, the illegitimacy rate has increased from 2.3 percent to 22 percent for whites and from 21.4 percent to 68 percent for blacks. A substantial part of the current generation of inner city young people has grown up without a father, a contributor to the increase in violent crime and the decline in school performance as well as to some of the pathologies addressed in this study.[2]

Nonemployment

The percent of the adult population that is not employed has been declining for many years and, compared to many other nations, is

[2]My earlier study of "Crime, Police, and Root Causes" (Niskanen 1994) estimated that a 1 percentage point increase in the births to single mothers increased the violent crime rate by about 1.7 percent. For the effect of illegitimacy on school performance, see Card (1981) and Hill and O'Neill (1994).

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unusually low. For lack of a better word, I will define this condition with the inelegant word nonemployment, because the word unemployment has usually been used to describe those not working but seeking work. Formally, the nonemployment rate is the percent of the civilian noninstitutional population age 16 and over that is not employed. On a national basis the nonemployment rate is 38.6 percent with a range from 31.1 percent in Nebraska to 51.7 percent in West Virginia.

Abortion

Abortion is the most contentious issue in contemporary American politics, primarily because the polar positions have dominated the debate. The "pro-choice" advocates consider any restriction on abortion as a violation of a woman's rights. The "pro-life" advocates consider any abortion as murder. No study of the causes and consequences of abortion would reconcile these positions. Most Americans, however, appear to favor legal and social rules that would make abortion legal, safe, and rare. For the most part, abortion is legal and safe but it is not rare. On a national basis there are 379 abortions per 1,000 live births (somewhat lower than the prior peak of 436 in 1983), with a range from 74 in Wyoming to 1,104 in the District of Columbia. For the broad group of Americans who regard most abortions as undesirable but not a crime, abortion is appropriately described as a pathology and an understanding of the conditions that explain the large variation in abortion rates can be valuable to aid their judgment on this contentious issue.

Violent Crime

Violent crime may be the most serious social pathology in the United States. The reported violent crime rate has increased substantially for several decades and is much higher than in other nations. And the number of violent crimes estimated from victimization surveys is much higher than the number reported to and by the police. On a national basis, there were 758 reported violent crimes per 100,000 residents, with a range from 83 in North Dakota to 2,833 in the District of Columbia.

Root Causes of the Culture of Poverty

One objective of this study is to identify the extent to which the six social pathologies are the consequence of a common set of root causes. The conditions examined included the level of welfare benefits in each state, a measure of general economic conditions, the racial and ethnic composition, and several social and cultural indicators.

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Welfare Benefits

The one variable that best reflects the welfare policy in a state is the level of AFDC benefits per recipient household. State governments also set eligibility standards subject to federal guidelines, but differences in these standards are not easily measurable. For this study, welfare benefits are defined as the annual AFDC benefits per recipient household as a percent of the pretax personal income per capita in the state. On a national basis such benefits are 23 percent of personal income per capita, with a range from 10.4 percent in Mississippi to 40.8 percent in Alaska.

Total welfare benefits per recipient household, one should recognize, are much higher than the direct cash benefits from AFDC. The total benefits for those households from AFDC, food stamps, and medicaid only range from 50 to 100 percent of personal income per capita. And the total benefits for those AFDC recipients who also receive housing assistance, utility assistance and specialized food programs range from 90 to 125 percent of personal income per capita.[3] These estimates of total benefits provide a better sense of why welfare has become a trap for so many women. For reasons that are not clear, however, the several measures of social pathology that are the focus of this study are more closely related to the narrow cash benefits from AFDC than to the broader measures of total welfare benefits, maybe because many AFDC recipients value cash benefits more than noncash benefits or are not eligible for the broader set of benefits.

Economic Conditions

General economic conditions in a state are represented by the pretax personal income per capita. On a national basis average personal income is $20,105, with a range from $14,082 in Mississippi to $27,909 in the District of Columbia.

Race and Ethnicity

The racial and ethnic composition in a state is represented by the percent black and the percent Hispanic. Blacks are 12.4 percent of the national population, with a range from 0.3 percent in Montana to 65.0 percent in the District of Columbia. Hispanics are 9.5 percent of the national population, with a range from 0.4 percent in West Virginia to 38.2 percent in New Mexico. These two groups are combined in a percent minority measure when preliminary tests indicate that their effects are not statistically different.

[3]For an analysis of the total level of welfare benefits by state, see Tanner, Moore, and Hartman (1995).

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Social and Cultural Indicators

Social and cultural conditions in a state are represented by four indicators: church membership, educational level, percent metropolitan, and average temperature. The distinctive attribute of each of these indicators is that they reflect individual choices of whether to join a church, continue education, and where to live.

Church membership is measured as the sum of the percent of the resident population who are Christian adherents (1990) plus the percent who are Jews. By this measure, 55 percent of the national population are church members, with a range from 32.6 percent in Alaska to 80 percent in Utah.

The educational level in a state is measured as the percent of the resident population age 25 and over with a high school or higher education (1990). On a national basis 75.2 percent are educated at this level, with a range from 64.3 in Mississippi to 86.6 percent in Alaska.

The metropolitan population is measured as the percent of the population resident in metropolitan areas. On a national basis 79.7 percent of the population are residents in a metropolitan area, with a range from 24 percent in Montana to 100 percent in the District of Columbia.

The average daily low temperature measure used in this study is roughly proportional to the distance from North Dakota. This variable, which is significant only in the welfare dependency regression, reflects some combination of the tighter welfare eligibility standards in the southern states and the social and cultural differences among regions that are correlated with temperature. Whatever the balance of these effects, including this measure is important to increase the precision by which the effects of other conditions is estimated.

Methodology

The patterns of pathology are estimated by least-squares regression techniques.[4] For each of the six pathologies, two types of relations are estimated: The first relation includes one or more other jointly determined pathologies and a subset of the root causes; this relation is estimated by a weighted two-stage (TS) regression where the whole set of root causes is used as instrumental variables. The first relation provides estimates of the relation among the several pathologies and

[4]For statistical reasons, the dependent variables in each of these regressions (other than for violent crime) are of the form $\log[P/(100-P)]$ where P is the percent of the residents of each state that are subject to the specific pathology. The coefficients presented in Tables 1–3, thus, are transformations of the direct regression results at the sample means. The direct regression results are available from the author on request.

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the partial effects of specific root causes *given* the level of the other included pathologies. The second relation includes only a set of root causes; the relation is estimated by a weighted least squares (LS) regression. The second relation provides estimates of the *total* effect of specific root causes that operate both directly on the specific pathology and indirectly through their effect on other related pathologies. All variables in both relations are weighted by the resident population of each state. This increases the relative effects of conditions in the largest states and makes the estimates correspond more closely to the effects of national conditions. Only those variables that are statistically significant at a 95 percent level or more are included in either of the relations; as it turns out, most of the included variable are significant at a much higher level.

Patterns of Social Pathology

The patterns of social pathology are summarized in Tables 1, 2, and 3. First, some general advice on reading these tables. The top tier of coefficients in each table are estimates of the percent change in the focus pathology from a 1 percent increase in some other condition. For example, in Table 1, a 1 percent increase in the poverty population in a state increases welfare dependency (the number of AFDC recipients) by about 0.6 percent. The lower tier of coefficients (except for temperature) are estimates of the percent change in the focus pathology from a 1 *percentage point* increase in some other condition. For example, in Table 1, a 1 percentage point increase in the population living in a metropolitan area increases the AFDC population by about 1.3 percent. The coefficients on the temperature variable are estimates of the effect of a 1 *degree* (Fahrenheit) increase in the average daily low temperature. The numbers in parentheses are the standard errors. If the estimate of the coefficient is unbiased, there is a 95 percent probability that the true (unknown) level of the coefficient is within two standard errors of the estimate. The $\overline{R}^2$ is the percent of the weighted and unweighted variance of the focus pathology among the states that is explained by each relation.

Welfare Dependency

The patterns of welfare dependency summarized by the first two columns of Table 1 support the following conclusions:

1. Welfare dependency is strongly related to poverty. Specifically, a 1 percent increase in the poverty population in a state increases the population of AFDC recipients by about 0.6 percent.

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TABLE 1

WELFARE AND POVERTY

	Welfare Dependency		Poverty	
	TS	LS	TS	LS
Effect of a 1 Percent Increase				
Dependency			.27	
			(.06)	
Poverty	.63			
	(.17)			
Income		−1.04	−.72	−.81
		(.29)	(.17)	(.18)
Effect of a 1 Percentage Point Increase				
Benefits	2.18	2.96		.75
	(.23)	(.26)		(.21)
Church	−.69		.41	.36
	(.15)		(.12)	(.15)
Education	−3.92	−4.25		−1.76
	(.88)	(.87)		(.68)
Metropolitan	1.05	1.31	−.40	
	(.17)	(.31)	(.18)	
Minority		.70	1.38	1.14
		(.31)	(.14)	(.15)
Temperature	−2.11	−2.15		
	(.36)	(.50)		
$\bar{R}^2$				
weighted	.99	.99	.99	.99
unweighted	.39	.21	.64	.67

2. An increase in AFDC benefits by 1 percent of personal income, about $17 a month in 1992, would increase the dependent population in a state by about 2.2 percent given the number of the poor and by about 3.0 percent including the effect on poverty. Some part of this increase may be induced immigration from other states, so the proportionate effects of a uniform national increase may not be as high.
3. Economic conditions and the minority population affect welfare dependency only through their effects on the poverty rate. A 1 percent increase in average personal income reduces dependency by about 1.0 percent. A 1 percentage point increase in the minority population increases the dependent population by about 0.7 percent.

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TABLE 2

OUT-OF-WEDLOCK BIRTHS AND NONEMPLOYMENT

	Out-of-Wedlock Births		Nonemployment	
	TS	LS	TS	LS
Effect of a 1 Percent Increase				
Dependency	.52		.13	
	(.11)		(.04)	
Nonemployment	.93			
	(.40)			
Effect of a 1 Percentage Point Increase				
Benefits		2.11		.49
		(.23)		(.12)
Church	−.42	−.36		
	(.19)	(.17)		
Education			−1.36	−2.00
			(.30)	(.34)
Metropolitan			.44	.49
			(.11)	(.10)
Black	.88	2.27		
	(.36)	(.36)		
Hispanic	−.68	−.48	−.39	−.44
	(.19)	(.17)	(.10)	(.10)
$\bar{R}^2$				
weighted	.95	.95	.93	.93
unweighted	.46	.44	−.51	−.41

4. Given the number of the poor, welfare dependency declines with an increase in church membership. A 1 percentage point increase in church membership reduces the dependent population by about 0.7 percent. A 1 percentage point increase in the population completing high school reduces the dependent population by about 4 percent. And a 1 degree (Fahrenheit) increase in average temperature is associated with a 2.1 percent decrease in the dependent population. This temperature effect probably reflects the tighter welfare eligibility standards in the southern states.
5. Urbanization increases dependency. A 1 percentage point increase in the population residing in metropolitan areas increases the dependent population by about 1.3 percent.

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TABLE 3

ABORTION AND VIOLENT CRIME

	Abortion		Violent Crime	
	TS	LS	TS	LS
Effect of a 1 Percent Increase				
Dependency			.61	
			(.16)	
Nonemployment	1.65			
	(.34)			
Income	1.03	1.42	−1.33	
	(.22)	(.16)	(.64)	
Effect of a 1 Percentage Point Increase				
Benefits		1.22		1.12
		(.24)		(.46)
Education	3.61			
	(.99)			
Metropolitan			.83	1.25
			(.37)	(.37)
Minority			1.27	
			(.43)	
Black	1.77	1.76		3.83
	(.41)	(.32)		(.66)
Hispanic	1.21	.82		1.91
	(.16)	(.15)		(.37)
$\overline{R}^2$				
weighted	.99	.99	.99	.99
unweighted	.44	.56	.59	.64

Most of these findings are expected, in direction if not in magnitude. Welfare dependency is primarily determined by the level of welfare benefits and the conditions that affect the poverty rate. One important finding is that an increase in the minority population does not increase dependency except to the extent that it increases the poverty rate. In other words, poor minorities are no more likely to be dependent on welfare than are poor whites. One puzzling finding is the positive effect of urbanization on dependency, given that urbanization (as also shown on Table 1) has a negative effect on the poverty rate; the urban poor are apparently more likely to be dependent on welfare than are the rural poor.

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Poverty

The patterns of poverty summarized by the last two columns of Table 1 support the following conclusions:

1. Poverty is also related to dependency. A 1 percent increase in the dependent population increases the poor population in a state by about 0.3 percent. An increase in AFDC benefits by 1 percent of average personal income increases the number of poor residents of a state by nearly 0.8 percent.
2. Poverty declines with an increase in average income and education. A 1 percent increase in average personal income reduces the poor population in a state by about 0.8 percent. A 1 percentage point increase in the population with high school or higher education reduces the poor population by about 1.8 percent.
3. The size of the poor population in a state is strongly related to the size of the black and Hispanic population. A 1 percentage point increase in the percent minority increases the poor population by about 1.1 percent.
4. For reasons that are not obvious, a 1 percentage point increase in church membership appears to increase poverty by about 0.4 percent.[5]

Again, most of these findings are expected. Poverty is primarily determined by the level of AFDC benefits, general economic conditions, education, and the percent minority. The major puzzle is the positive effect of church membership on poverty, compared to its negative effect on welfare dependency.

Out-of-Wedlock Births

The patterns of out-of-wedlock births summarized by the first two columns on Table 2 support the following conclusions:

1. Out-of-wedlock births are strongly related to welfare dependency. A 1 percent increase in the welfare dependent population in a state increases the number of births to single mothers by about 0.5 percent.
2. Illegitimacy is also related to nonemployment. A 1 percent increase in the nonemployed population increases the births to single mothers by about 0.9 percent.
3. The level of welfare benefits, in turn, indirectly increases illegitimacy through the effects on the size of the dependent population

[5]The substitution of the nonemployment rate for the church membership rate (not shown) yields a strong positive effect of nonemployment on poverty with only slightly weaker statistical results.

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and on the number of the nonemployed. An increase in AFDC benefits by 1 percent of average income increases the number of births to single mothers by about 2.1 percent.

4. Out-of-wedlock births decline with an increase in church membership. A 1 percentage point increase in church membership reduces the number of illegitimate births by about 0.4 percent.
5. In this case, the effects of the two large minority groups are very different. A 1 percentage point increase in the black population increases the number of illegitimate births by about 2.3 percent. In contrast, a 1 percentage point increase in the Hispanic population reduces the number of illegitimate births by about 0.5 percent.

Nonemployment

The patterns of nonemployment summarized by the last two columns of Table 2 support the following conclusions:

1. Welfare dependency reduces employment. A 1 percent increase in the dependent population increases the number who are not employed by about 0.1 percent.
2. An increase in welfare benefits reduces employment by increasing the number of welfare dependents. An increase in AFDC benefits by 1 percent of average income increases the number who are not employed by about 0.5.
3. Education has a strong effect on employment. A 1 percentage point increase in the population with high school or higher education reduces the number who are not employed by about 2 percent.
4. Employment is also related to the relative size of the metropolitan and Hispanic populations. A 1 percentage point increase in the metropolitan population increases the number who are not employed by about 0.5 percent. A 1 percentage point increase in the Hispanic population reduces the number who are not employed by about 0.4 percent.

Abortion

The patterns of abortion summarized by the first two columns of Table 3 support the following conclusions:

1. Abortion is strongly related to nonemployment. A 1 percent increase in the adult population not working increases the number of abortions by about 1.7 percent.[6]

[6]The substitution of the dependency rate for both the nonemployment rate and the education rate (not shown) yields a strong positive effect of the dependency rate on abortion with only slightly weaker statistical results.

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2. An increase in AFDC benefits by 1 percent of average income would indirectly increase the number of abortions by about 1.2 percent by increasing the nonworking population.
3. A 1 percent increase in average income increases the number of abortions by about 1 percent.
4. Education, like income, contributes to abortion. A 1 percentage point increase in the population with education at the high school level or higher, for a given number of nonemployed, increases the number of abortions by about 3.6 percent.
5. The effects of the two large minority groups are somewhat different. A 1 percentage point increase in the black population increases the number of abortions by about 1.8 percent, whereas a 1 percentage point increase in the Hispanic population increases abortions by about 0.8 percent.

The pattern of abortions is *not* consistent with the usual patterns of the culture of poverty. The number of abortions increases with nonemployment and the percent minority, but it also increases with education and income. Maybe the most surprising finding is another blank space: the number of abortions appears to be independent of church membership.

Violent Crime

The patterns of violent crime summarized by the last two columns of Table 3 support the following conclusions:[7]

1. The level of violent crime is strongly related to welfare dependency. A 1 percent increase in the welfare dependent population increases the violent crime rate by about 0.6 percent.
2. An increase in welfare benefits indirectly increases the violent crime rate by increasing the number of welfare dependents. An increase in AFDC benefits by 1 percent of average income increases the violent crime rate by about 1.1 percent.
3. The level of violent crime is also related to the composition of the population, reflecting both a direct effect and an indirect effect operating through the level of the welfare dependent population.[8] A 1 percentage point increase in the metropolitan population increases the violent crime rate by about 1.3 percent.

[7]This regression also includes the number of police per 10,000 residents (not shown) as a jointly determined control variable.

[8]The substitution of the divorce rate for both average income and the metropolitan percent (not shown) yields a strong positive effect of divorce on violent crime with only slightly weaker statistical results.

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A 1 percentage point increase in the black population increases the violent crime rate by about 3.8 percent, and a 1 percentage point increase in the Hispanic population increases the violent crime rate by about 1.9 percent.

Patterns Across Pathologies

A comparison of the effects of the eight root causes across the six pathologies is useful to identify the conditions that most consistently contribute to or defend against these pathologies.

The level of AFDC benefits relative to the average personal income in each state is the one condition that increases each of the six focus pathologies, with effects ranging from a weak effect on nonemployment to disturbingly strong effects on welfare dependency and illegitimacy.

The next most consistent correlate of these conditions is the percent of the population that is black, a root cause for five of the pathologies other than nonemployment. The percent Hispanic contributes to welfare dependency, poverty, abortion, and violent crime but reduces illegitimacy and nonemployment.

The most consistent defenses against these pathologies are education and higher average income. A higher percent of the population with high school or higher education reduces dependency, poverty, and nonemployment. Higher average income reduces dependency, poverty, and violent crime. Both higher education and income, however, increase abortion.

The effects of the other conditions examined are more mixed. Church membership reduces welfare dependency and illegitimacy but appears to increase poverty. A higher percent of the population of a state that is resident in metropolitan areas increases dependency, nonemployment, and violent crime but reduces poverty. The contrary effects of church membership and the metropolitan population on welfare dependency and poverty are probably the most puzzling results of this study.

The Good Samaritan's Dilemma

For the most part, the political support for welfare reflects a generous motive to help those who are poor, single, and with children. Welfare would provoke little controversy and benefits would probably be higher if these conditions were substantially accidental or temporary—the result, for example, of the death, disability, or temporary unemployment of the major contributor to a family's income. That is why welfare was first promoted as a widow's allowance. That is why

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President Clinton supports welfare as a safety net but not as a way of life. The moral dilemma, of course, is that welfare, like most forms of social insurance, increases the number of people with the insured condition. This study, for example, estimates that an increase in AFDC benefits per household by 1 percent of average income would increase the number of welfare dependents by about 3.0 percent and the number of births to single mothers by about 2.1 percent.

There is no obvious resolution of this age-old dilemma, and I claim no special moral insight. The patterns of pathology associated with the current welfare system, however, no longer seem acceptable, not so much because of their fiscal cost but because of their malign effects. The welfare legislation that Congress recently approved will give the state governments a greater incentive and opportunity to experiment with different approaches to welfare. The effects of this major welfare reform are difficult to predict, because state governments will have more flexibility to set benefit rates and eligibility conditions and there are many types of exemptions from the remaining federal mandates. The most important change is probably the substitution of lump-sum payments to the states for the current system of matching grants; this will increase the marginal cost to state taxpayers from the current 20 to 50 percent of AFDC benefits to 100 percent.

This study suggests that the state governments may be best advised to focus welfare on the innocent—widows, the genetically or accidently disabled, and children—and to set firm time limits on the welfare eligibility of others. Education and a strong general economic climate appear to be the most effective policy-responsive conditions to reduce the remaining pathologies. A blind compassion may be admirable but a knowledgeable compassion is twice blest.

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Bank Failures, Systemic Risk, and Bank Regulation

George G. Kaufman

Bank (depository institutions) failures are widely perceived to have greater adverse effects on the economy and thus are considered more important than the failure of other types of business firms. In part, bank failures are viewed to be more damaging than other failures because of a fear that they may spread in domino fashion throughout the banking system, felling solvent as well as insolvent banks.[1] Thus, the failure of an individual bank introduces the possibility of systemwide failures or systemic risk. This perception is widespread.[2] It appears

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[1]Some argue that not only banks but all financial firms are potential sources of systemic risk. For example, in their study of capital requirements for securities firms, Dimson and Marsh (1995, p. 823) note:

> Implicitly, competition is assumed to generate appropriate capital structures, and the financial distress costs are an integral part of their decision process. Most countries take a different line for financial businesses, however. The systemic costs of default. . .have persuaded regulators to impose minimum capital requirements.

See also Davis (1992).

[2]The public fear of systemic risk in the financial sector and in banking in particular is intensified both by its relative lack of understanding of financial matters and by a constant barrage of fictional "scare" stories. Most persons are far more baffled and mystified about how firms dealing in intangibles, such as banks, operate than how firms dealing in tangibles, such as automobile companies, operate. Thus, they have greater difficulty distinguishing between factual and folklore explanations of the causes and effects of breakdowns in the financial system than elsewhere and their perceptions are more likely to reflect the greater fear generally shown of the unknown than the known. Superstitions gain credence. In addition, potential severe adverse contagious effects of bank failures and financial market crashes have long been a popular subject for novelists, who spin colorful and frightening stories, and movie makers. For example, the human blight caused by bank failures is vividly described in the best-selling novel of the mid-1990s, *A Dangerous Fortune*, by the best-

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to exist in almost every country at almost every point in time regardless of the existing economic or political structure. As a result, bank failures have been and continue to be a major public policy concern in all countries and a major reason that banks are regulated more rigorously than other firms.[3]

Unfortunately, whether bank failures are or are not in fact more important than other failures, and I will argue in this paper that they are not, the prudential regulations imposed to prevent or mitigate the impact of such failures are frequently inefficient and counterproductive. Mark Flannery (1995) comes to a similar conclusion. The regulators have often increased both the probability of bank failure and the costs of such failures. In the process, the regulations have tended to socialize the costs of failure by shifting them from private depositors of the failed banks to general taxpayers.

In addition, the imposition of prudential regulations has identified banking as "unique," and at times has involved potential government financial assistance. This has often made it easier for governments to justify imposing other regulations that have primarily social and political objectives and are often in conflict with the objectives of the prudential regulations, e.g., credit allocation schemes.[4] However, the bulk of the evidence suggests that the greatest danger of systemic risk comes not from the damage that may be imposed on the economy from a series of bank failures, but from the damage that is imposed on the economy from the adverse effects of poor public policies adopted to prevent systemic risk. As a result, it can be argued that the poor performance of banking experienced in almost all countries

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selling author Ken Follet (1994). More recently, the *Washington Post,* which prides itself on accuracy in reporting, published a fiction story disguised as a news article about the potential collapse of the world financial markets from a default by the U.S. Treasury during the budget crisis of January 1996, authored by long-time successful scare monger and best-selling author Paul Erdman (1996).

[3]Gerald Corrigan (1991: 3), former president of the Federal Reserve Bank of New York, has noted:

> More than anything else, it is the systemic risk phenomenon associated with banking and financial institutions that makes them different from gas stations and furniture stores. It is this factor—more than any other—that constitutes the fundamental rationale for the safety net arrangements that have evolved in this and other countries.

[4]Although not the subject of this paper, credit allocation schemes, which have been a major cause of bank insolvencies, particularly at state owned or controlled banks, in many developing and traditional economies, are not possible without a government safety net that removes the concern of depositors. Indeed, many authors, including Kane (1989) and Kaufman (1995a), have pointed to credit allocation in favor of residential housing in the form of encouraging long-term fixed rate mortgage loans funded by short-term deposits as a major cause of the savings and loan debacle in the United States in the 1980s.

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in the last two decades reflects primarily regulatory or government failures, rather than market failures. Prevention of reoccurrences of the recent banking problems requires better developed and more incentive-compatible and market-assisted prudential regulation and reduced nonprudential regulations.

Implications of Bank Failures

A bank fails economically when the market value of its assets declines below the market value of its liabilities, so that the market value of its capital (net worth) becomes negative. At such times, the bank cannot expect to pay all of its depositors in full and on time. The bank, or indeed any firm, should be resolved as quickly as possible in order to treat all depositors (creditors) fairly and not allow a run by depositors holding demand and short-dated deposits. The longer an insolvent bank is permitted to operate, the more time such informed depositors have to withdraw their funds at par value and effectively strip the bank of its valuable assets. The entire loss will then be borne by less informed depositors and holders of longer-dated deposits.

In most countries, the failure of an individual bank should be no more important than the failure of any other firm of comparable size in the community. This is particularly true today when most bank products are no longer unique and are being provided in many countries by an ever growing number of nonbank firms that are gaining market share at the expense of banks. Moreover, to the extent that bank or branch office charters are not restricted, if the demand for banking services in the community is sufficiently strong, a new bank or office should be expected to enter. In the absence of deposit insurance, potential adverse effects to the community would be minimized, the faster the insolvent bank is resolved and the smaller the losses to depositors.

This is not to argue that bank failures are costless. Losses accrue to shareholders and most likely also to depositors, unsecured creditors, and the deposit insurer. Small loan customers may be particularly inconvenienced by changes in their loan officers, loan standards, and other aspects of their ongoing bank relationship. But this is no different from the losses and disruptions in firm-customer relationships that accompany the failure of almost any business entity of comparable size in the community.

What makes at least the perception of bank failures more important, particularly for public policy, is the fear that the failure may spill over to other banks and possibly even beyond the banking system to the financial system as a whole, the domestic macroeconomy, and other

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countries. Similar fears are generally not perceived for the failure of other firms. The failure of a steel mill, software manufacturer, or grocery store is not widely perceived to spill over to other firms in the same industry. Indeed, as Larry Lang and Rene Stulz (1992) note, the surviving firms frequently benefit from losing a competitor and being able to expand their market shares.

Whether or not bank failures are more serious than other failures, individual banks are viewed as more susceptible to failure or more "fragile" than other firms and the banking industry more susceptible to contagion than other industries. Banks are viewed as more fragile for three reasons (Kaufman 1996). They have (1) low capital-to-assets ratios (high leverage), which provides little room for losses; (2) low cash-to-assets ratios (fractional reserve banking), which may require the sale of earning assets to meet deposit obligations; and (3) high demand debt and short-term debt-to-total debt (deposits) ratios (high potential for a run), which may require hurried asset sales of opaque and nonliquid earning assets with potentially large fire-sale losses to pay off running depositors.

The adverse implications of this fragility are intensified by the fear that banks invest in assets that are opaque, illiquid and difficult to market, contain private information, and can change in market value abruptly; and the fear that depositors may run "irrationally" on banks, forcing unnecessarily large fire-sale losses. Thus, the greater fragility is believed to lead to greater failure.

Moreover, because banks are closely intertwined financially with each other through lending to and borrowing from each other, holding deposit balances with each other, and the payments clearing system, a failure of any one bank is believed to be more likely to spill over to other banks and to do so more quickly. Thus, the banking system is seen as more susceptible to systemic risk, where I define systemic risk as "the probability that cumulative losses will occur from an event that ignites a series of successive losses along a chain of institutions or markets comprising a system (Kaufman 1995b: 47).[5] A default by

[5]This definition is consistent with the one used by the Bank for International Settlements (BIS) (1994: 177):

> Systemic risk is the risk that the failure of a participant to meet its contractual obligations may in turn cause other participants to default, with the chain reaction leading to broader financial difficulties.

and by Robert Parry (1996: 2), president of the Federal Reserve Bank of San Francisco:

> Systemic risk is the risk that one bank's default may cause a chain reaction of. . .failures and even threaten the solvency of institutions.

Alternative definitions are developed in Bartholomew and Whalen (1995). The importance of defining systemic risk accurately has recently been emphasized by Alan Greenspan (1995: 7), chairman of the Board of Governors of the Federal Reserve System, when he noted:

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one bank on an obligation to another bank may adversely affect that bank's ability to meet its obligations to other banks and so on down the chain of banks and beyond.

In a recent review of the literature on bank contagion, I identified five reasons that have been cited for more serious contagion in banking than in other industries (Kaufman 1994). In banking, contagion is perceived to (1) occur faster; (2) spread more widely within the industry; (3) result in a larger number of failures; (4) result in larger losses to creditors (depositors) at failed firms; and (5) spread more beyond the banking industry to other sectors, the macroeconomy, and other countries. I concluded that the evidence suggests that, while contagion in banking may be faster, be more likely to spread to a larger percent of the industry, lead to a larger number of failures, and be more likely to spill over beyond banking, losses to depositors at failed institutions—the primary transmitter of systemic risk—are smaller and bank runs—which can increase the risk by increasing the losses—tend to be informational and bank specific. At least marginal depositors are generally able to differentiate solvent from insolvent banks, particularly when they are given the incentive to do so by the fear of suffering losses. As a result, contrary to folklore, bank contagion on a nationwide scale has not been a common experience and, while large-scale banking failures exacerbate economic downturns, they do not appear to start them.

Nevertheless, the perception of both great likelihood and great damage persists and much extant prudential bank regulation is based on this perception. The remainder of this paper examines the potential for systemic risk in banking more carefully and recommends public policy initiatives that would greatly reduce, if not eliminate, this risk.

Systemic Risk and Public Policy

Although banking may be more fragile than other industries, this does not imply a higher breakage or failure rate. Rather, greater fragility implies "handle with greater care," much as it does with glass and porcelain objects. And apparently that is what the private market did in the United States when the proper incentives to encourage

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It would be useful to central banks to be able to measure systemic risk accurately, but its very definition is still somewhat unsettled. It is generally agreed that systemic risk represents a propensity for some sort of significant financial system disruption. Nevertheless, after the fact, one observer might use the term "market failure" to describe what another would deem to have been a market outcome that was natural and healthy, even if harsh. . . . Until we have a common theoretical paradigm for the causes of systemic stress, any consensus of how to measure systemic risk will be difficult to achieve.

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such behavior were in place. Before the introduction of government safety nets, banks held considerably higher capital ratios and assumed considerably less credit and interest rate risks in their portfolios. The average annual failure rate for U.S. banks from the end of the Civil War in 1865 to before the establishment of the Federal Reserve System in 1914 was somewhat lower than for nonbank firms, although the annual variance was greater (Kaufman 1996). In addition, losses to depositors as a percent of deposits at failed banks were lower than losses to creditors at failed nonbanks (Kaufman 1994). Jack Carr, Frank Mathewson, and Neil Quigley (1995) describe the stability of the Canadian banking system before the introduction of deposit insurance in 1967. Anna Schwartz (1988) argues that until the recent worldwide rash of bank failures—which are described in Herbert Baer and Daniela Klingebiel (1995), Gerald Caprio and Daniela Klingebiel (1995), Gillian Garcia (1995), Charles Goodhart (1995, particularly chapter 16), and Zenta Nakajima and Hiroo Taguchi (1995)—while banks failed, bank panics and contagion had almost disappeared in developed countries, other than the United States, by the late 1920s.

Ironically, the introduction of government regulations and institutions in the United States intended to provide protection against the fragility of banks appears to have unintentionally increased both the fragility of the banks and their breakage rate. By providing a poorly designed and mispriced safety net under banks for depositors, first through the Federal Reserve's discount window lender of last resort facilities in 1914, and then reinforced by the FDIC's deposit guarantees in 1934, market discipline on banks was reduced substantially. As a result, the banks were permitted, if not encouraged, to increase their risk exposures both in their asset and liability portfolios and by reducing their capital ratios. As noted by Edward Kane (1985, 1989, and 1992), George Benston and Kaufman (1995), Kaufman (1995a), George Selgin (1989), and others, this represents a classic and predictable moral hazard behavior response. Public (taxpayer) capital has largely replaced private (shareholder) capital as the ultimate protector of depositors. For example, in its 1994 *Annual Report*, the FDIC (1995: 35) declared that "the FDIC remains today the symbol of banking confidence."[6]

[6]Much of the general public considers the government to be the ultimate guarantor of nearly all financial transactions, regardless of the size or type of transaction. In his analysis of the Daiwa Bank's problems in the United States, Robert Samuelson (1995: 5), a well-known economic columnist, writing in the *Washington Post*, noted:

> Financial markets (banking, the trading of securities) depend upon trust and confidence. Hundreds of billions of dollars of daily transactions occur on nothing more than a phone call or a computer key. . . .In part, trust rests on faith that

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Moreover, it could also be argued that the introduction of the safety net encouraged the federal government to impose greater risk on the banks. For example, national banks were not permitted to make mortgage loans before the Federal Reserve Act in 1913 and then only one-year loans until 1927. Likewise, the government did not encourage banks and thrifts to make long-term fixed-rate mortgages until after the introduction of deposit insurance. It is interesting to speculate whether the government would have introduced such risk-increasing policies in the absence of a safety net.

But, in addition, as repeatedly emphasized by Kane (1989, 1995a and b), the establishment of the Federal Reserve and FDIC in the U.S. introduced severe principal-agent problems. The Federal Reserve was charged with acting as the lender of last resort to the macroeconomy by, among other things, offsetting the impact of losses of reserves from the banking system for reasons such as a run to currency by depositors or gold outflows that threatened to reduce the money supply below appropriate levels. But the Federal Reserve was given discretion with respect to when and to what extent to do so. Unfortunately, as Milton Friedman and Anna Schwartz (1963) document, when the banking system experienced a run into currency during the Great Depression from 1929 to 1933, which dramatically reduced aggregate bank reserves, money supply, and bank credit, the Federal Reserve failed to inject sufficient offsetting reserves. As a result, the simultaneous attempt by nearly all banks to contract by selling assets led to large fire-sale losses and the largest number of bank failures in U.S. history.

To prevent another misuse of discretionary power, the FDIC was effectively established to automatically guaranty a given dollar amount of deposits per bank account. Most depositors would, therefore, have little, if any, reason to run on their banks regardless of the bank's

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government regulators will supervise the complex payments system and police for fraud and financial failure.

Likewise, Robert Kuttner (1991: 28), another *Washington Post* columnist, ended his column on deposit insurance, the troubled Bank of New England (which failed shortly thereafter), and why he did not join the "irrational" run, by noting:

> So my account is still at the Bank of New England. And my money is still at the FDIC.

Even some bankers do not believe that depositors should look only to their banks for safety. In criticizing the banking agencies' proposed capital requirements for market risk, Fox (1995: 3) reported that Jill Considine, president of the New York Clearing House Association, argued:

> These standards are "unnecessarily rigid and extremely conservative.". . .The market risk rules should be used to "protect banks against normal market risks in their portfolios, [not] as a tool to protect the banking system against systemic risk."

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financial condition. Rules were imposed to supplant discretion. But the law of unintended consequences was not absent. The absence of runs removed a major automatic mechanism by which troubled banks were previously closed and resolved. Runs on troubled banks caused liquidity problems, which forced regulators to suspend their operations until their solvency could be determined. In this way, depositors prevented insolvent institutions from remaining in operation for long and thereby limited the ability of these banks to enlarge their losses.

In contrast, after deposit insurance ended most runs, the bank agencies were able, for whatever reason, to permit insolvent banks to remain in operation and continue to generate losses. The failure of the late Federal Savings and Loan Insurance Corporation (FSLIC) to promptly resolve insolvent savings and loan associations in the 1980s, led to its own insolvency, the shifting of its approximate $150 billion negative net worth to the U.S. taxpayer, and a record number of thrift failures. Capital forbearance was also practiced in this period by the FDIC for commercial banks with high costs that were, however, able to be absorbed by the FDIC, primarily because a sharp fall in interest rates in the early 1990s, an equally sharp steepening in the yield curve, and new federal legislation requiring recapitalization of banks abruptly improved the economic health of the surviving banks before the FDIC's cash reserves ran out (Brinkmann, Horvitz, and Huang 1996; Kaufman 1995a).[7]

The forbearance not only contributed to increasing the cost of bank failures, but, by delaying the imposition of regulatory sanctions on troubled institutions, also contributed to increasing the number of failures. The average annual bank failure rate (1.09 percent) after the imposition of the initial bank safety net by the Federal Reserve in 1914 (1914–94) somewhat exceeds that (0.91 percent) for the pre–safety net period (1870–1913). This increased occurred despite a sharp decline in the nonbank failure rate from 1.01 percent to 0.65 percent. This suggests that the failure of the bank failure rate to decline likewise could not be attributed to increased instability in the economy or reduced market discipline, but rather to the adverse effects of the moral hazard and agency problems introduced by the poorly designed safety net.

Paradoxically, the Federal Reserve, the FDIC, and FSLIC used their discretionary authority in opposite directions with equally adverse effects for the economy. Friedman and Schwartz (1963) argue convincingly that the Federal Reserve was overly restrictive in the 1930s. In the 1980s, however, after the government had introduced a system that

[7]The FDIC's reserves were estimated to have been negative, however, if adjusted for expected bank failures and losses.

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would prevent overrestrictiveness, not underrestrictiveness (which had not been a problem in the 1930s), both the FDIC and FSLIC used their discretionary powers to be less restrictive on troubled insured institutions than they should have been. In retrospect, both agencies were poor agents for their principals—the Congress, taxpayers, and healthy banks and thrifts that paid premiums to the insurance funds.

The Causes of Systemic Risk

To design public policies that can efficiently prevent the fragility of banks to be translated into a high failure rate, it is necessary to understand the potential causes of both individual bank failures and systemic risk. The causes of individual bank failure have been considered adequately by J.F.T. O'Conner (1938) and Fred Graham and James Horner (1988), among others, and need not be reconsidered here. The same is less true for systemic risk, although an exception is E.P. Davis (1992).

Systemic risk is perceived to occur because all economic agents are interconnected. This interconnection provides a chain along which shocks to any one agent are transmitted to others. The personal or institutional balance sheet of each agent includes assets that are either liabilities of other agents or whose values depend on the behavior of other agents. Likewise, the liabilities of each agent are the assets of others. If an agent suffers a decline in the value of its assets, the value of its capital will decline. This will likely reduce the spending behavior of the agent and thereby also the income and asset values of other agents. Moreover, if the loss in asset values were sufficiently large to exceed an agent's capital, it would cause the agent to default on its debt obligations. This, in turn, will reduce the values of assets on the balance sheet of the agent's creditors and ignite a chain reaction of reduced spending and defaults.

Losses to shareholders are generally viewed as less serious than losses to creditors, who are assumed more risk averse and often consider themselves not fully compensated for any losses they may experience. This is particularly true for depositors, who generally view these funds as the safest and most liquid component of their wealth portfolios. Thus their "harm" is greater and their response in rearranging their portfolios to avoid further losses is more severe. However, it should be noted that defaults lead primarily to redistributions in wealth rather than to aggregate reductions, as the creditor's loss is the debtor's gain. But the economic impacts are unlikely to be offsetting. The consequences of the losses outweigh those of the gains.[8]

[8]A more complete listing of alternative paths along which systemic risk may travel appears in Schwartz (1995).

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Because of their continuous lending to and borrowing from each other and their need to pay other banks for third-party transfers, banks tend to be more tightly financially interconnected with each other than are most other types of firms. Thus, banks are widely perceived to be particularly susceptible to systemic risk, and shocks at any one bank are viewed as likely to be quickly transmitted to other banks, which in turn can transmit the shock down the remaining chain of banks. The adverse cumulative effects of the initial shock are intensified because bank deposits make up the larger part of most countries' money supply. As a result, depositors experiencing losses are likely to cut back on their spending by more than they would for an equal dollar reduction in other, less liquid forms of wealth. Such cutbacks will, in turn, reduce the income of other agents and thereby also their spending. Any impact of the reduced money supply, however, may be offset by deposit expansion by solvent banks that now have excess reserves or by the central bank through the injection of additional reserves.

Absent deposit insurance protection, bank depositors tend to be aware of the unique fragility of banks. If they perceive a shock to their bank or banks to be sufficiently great to threaten the solvency of those banks, they are likely to withdraw their deposits in anticipation of a default by the banks. Banks must sell assets quickly to pay these depositors, so that such a run is likely to lead to liquidity problems and fire-sale losses, which would both accelerate and intensify the transmission of the shock. Of course, for a given adverse shock, the greater capital a bank has, the less likely is it to default. In the absence of full deposit insurance, bank customers are thus motivated to encourage their banks to hold sufficient capital to avoid default from adverse shocks originating at other banks.

Runs occur in response to an actual or perceived default and, while they may hasten the transmission to other banks, Frederic Mishkin (1991) and Selgin (1992) show that they generally do not ignite the initial shock. The poor financial state of the bank is unlikely to have started with the run. Although popular in folklore, Benston and Kaufman (1995), Charles Calomiris and Gary Gorton (1991), and Carr, Mathewson, and Quigley (1995) document that history provides little evidence that liquidity problems caused by runs drove economically solvent banks into insolvency.[9] Benston et al. (1986) and Kaufman (1988) note that the effects of a run on the bank, other banks, and

[9]An example of the more common view is provided by Krugman (1994: 38–39), who states, without analysis, that in the 1930s there was "a wave of bank failures, which proved self-reinforcing as it led to runs on banks that otherwise might have survived."

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the macroeconomy will depend on the running depositors' perception of the financial solvency of other banks. If they perceive some other banks in the system to be solvent and redeposit at those institutions, the effect of the run in terms of aggregate impact will be relatively small. There will be no or only little change in aggregate bank deposits or credit. Some adverse effects will be suffered by customers whose relationships with their banks might be changed or terminated, but, as discussed earlier, this is no different from the costly effects of any firm failure, and does not make bank failure a special public policy concern.

However, if the running depositors do not perceive any bank in their market area to be safe, they may flee into safe nonbank securities, most likely those of the federal government. Ownership of the deposits is transferred to the sellers of the securities and the implications depend on what they do with the deposits. If the sellers perceive other banks in their market area to be sufficiently financially secure, as is likely to be the case for the sellers to sell the safe securities, the funds will be redeposited in those banks. Again, there are no changes in either aggregate bank deposits or credit, only a redistribution of the banks holding the deposits. Adverse effects, however, may be somewhat greater than in the earlier direct redeposit scenario. Not only may some bank–customer relationships deteriorate, but the initial shift to government securities will bid up the prices and lower the interest rates on public securities relative to private securities. This may redirect investment from private to public sectors.

Moreover, if the perceived safe banks are located in a foreign country and the deposits are denominated in domestic currency, the first country's exchange rates will depreciate if the running depositors or receiving banks do not wish to hold the funds in that country's currency. The importance of this impact depends on the size and international openness of the country. For large countries, neither effect is likely to be sufficiently important to justify special public policy concern. For smaller, open countries, however, the percentage of deposits fleeing abroad is likely to be larger and the depreciation in their exchange rates is likely to be more important. If such a country attempts to offset the decline, it will run down its holdings of foreign reserves. To the extent the central bank cannot offset the impact of this loss on bank reserves, the country will experience a contraction in its money supply. Thus, for smaller countries, a run or a threat of a run to banks in other countries is more likely to be a special public policy concern.

If neither the running depositors nor the sellers of the government securities perceive any bank in any country to be sufficiently sound to warrant a redeposit, then there will be a flight to currency. The

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increase in currency held by the public will, unless offset by the central bank, reduce aggregate bank reserves and ignite a multiple contraction in bank assets and deposits. In the process, fire-sale losses will be greater and bank failures more frequent. Systemic problems are likely to occur. Indeed, it is a depositor run to currency that enlarges fire-sale losses and is likely to produce the major adverse effects generally perceived to result from widespread bank failures. In this scenario, banking becomes a special public policy concern.

Public Policy Remedies

What can public policy do to further mitigate the likelihood of systemic risk in banking and its severity if it does occur? For the sake of reality, we assume that some form of government deposit insurance, like central banks, is a political fact of life. Indeed, the evidence for countries that do not have explicit government insurance indicates that they generally have implicit 100 percent insurance. In the absence of permanently abolishing such insurance, there are three basic options.[10]

1. Policy can be directed at increasing macroeconomic stability and avoiding first abrupt increases and then declines (bubbles) in asset values and defaults. Schwartz (1988) and Goodhart (1995, particularly chapter 14) show that such instability has been a major cause of bank failures. Unfortunately, history has amply demonstrated that our current knowledge of macroeconomics is far short of what is required to achieve such results consistently.
2. Discretionary powers can be delegated to bank regulatory agencies to provide a safety net under banks to prevent both undue fire-sale losses from hurried asset sales by banks from affecting depositors and runs on the banking system into currency that exacerbate such losses. As noted earlier in this paper, it appears highly unlikely that such agencies, for example the Federal Reserve and FDIC, can do much better in the future than they have in the past in avoiding serious agency problems for themselves and moral hazard behavior by banks.

[10]All these options assume that the banks in the country start with a positive net worth or if not have, at minimum, a schedule for regaining positive net worth. These policy options do not deal with the issue of who pays for any negative net worth that banks may have—depositors, positively capitalized banks, taxpayers, or some other party. Kaufman (1997, forthcoming) notes that this is as much a political problem as an economic problem and the basis for much poor macroeconomic policy as many governments assume responsibility for the negative net worths and monetize this addition to their deficits.

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3. Policy can be directed at avoiding the pitfalls of excessively discretionary and incentive incompatible safety nets and other prudential policies and focus directly on the cause of both losses to depositors in bank insolvencies and depositor runs on banks, namely economic insolvency of banks with negative net worth. Such a policy would attempt to reduce, if not eliminate, both moral hazard behavior by banks and agency problems by regulators by properly aligning the incentives of all parties in the same and appropriate direction. The incentive for banks to engage in moral hazard behavior can be reduced by requiring sufficient private capital and imposing a series of sanctions in the form of structured early intervention or prompt corrective action on troubled banks that mimic the sanctions imposed by the private market on troubled noninsured bank competitors in an attempt to have the banks reverse direction before insolvency. The ability of regulators to incur principal-agent problems is reduced by having them be required to impose these sanctions on troubled institutions and to resolve a bank which was not turned around by these sanctions through recapitalization by current shareholders, sale, merger, or liquidation before its capital could be totally depleted and losses imposed on depositors. The best way to reduce the costs of bank insolvencies to "innocent" third parties is to restrict them solely to shareholders, who may be expected to be more aware of the risks and be compensated for them more commensurately.

Benston and Kaufman (1988, 1994a), Benston et al. (1989), Richard Carnell (1992), and the Shadow Financial Regulatory Committee (1992) describe how many of the parts of such a structured early intervention and resolution (SEIR) program are included in the prudential prompt corrective action and least-cost resolution provisions of the FDIC Improvement Act (FDICIA) enacted in the United States at yearend 1991. Unfortunately, the prompt corrective action and least-cost resolution provisions of FDICIA as well as the implementing regulations were weakened by Congress and particularly by the regulators both before and after the act was enacted, so that failure and losses will be larger than necessary. In particular, Benston and Kaufman (1994b) argue that the numerical values for the capital tripwires are set too low.

The SEIR program focuses on the following six areas:

1. Explicit full government deposit insurance for "small" depositors. Full insurance would be provided up to a specified maximum amount per account and no insurance would be provided

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above that amount. The precise amount at which to cap the insurance is difficult to establish theoretically, but should be near the level that depositors with larger amounts may be expected to have other investments that require the ability, knowledge, and experience to evaluate creditworthiness and may be widely expected to bear losses without much public sympathy and are unlikely to be able to conduct their business in currency and therefore run into currency rather than to other banks. These depositors would not only not be protected by deposit insurance, but would be expected to monitor and discipline their banks through market forces and thereby supplement regulatory discipline. Explicit full deposit insurance for small depositors is desirable, because (a) social externalities exist in providing a safe depository in the intermediation process for funds owned by agents for whom the costs of financial analysis of private banks outweigh the benefits, (b) these depositors are the most likely to run into currency and threaten systemic problems, and (c) insurance for such depositors is a political reality in almost all countries and explicit guarantees are more likely than implicit guarantees to avoid political battling when a failure does occur, which generally will result in the government providing full coverage and signal the willingness of the government to retreat in the face of pressure (Kaufman 1996).

2. Capital levels on banks that are equal to those that the private market expects noninsured bank competitors to maintain in the particular country. This provision is supported by Davis (1992), Flannery (1995), and Kaufman (1992). Thus, insured banks would increase their self-insurance to more market-determined levels.[11]
3. A system of graduated regulatory sanctions imposed on banks as their performance deteriorates through a series of zones (tranches or tripwires) that resemble the sanctions imposed by market forces on noninsured firms through bond covenants and creditor negotiation.[12] These sanctions are explicit, publicly announced, and become progressively harsher and more mandatory as the financial condition of the bank deteriorates through the tranches. (The sanctions introduced under FDICIA and the capital levels defining each tranche are shown in Table 1.)

[11]Merton (1995) identifies three ways for banks to reduce their risk exposures: (1) hedging, (2) insuring with others, and (3) a capital cushion.

[12]The effectiveness of private market sanctions in reducing moral hazard behavior on noninsured nonbank firms is examined by DeAngelo and DeAngelo (1990).

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4. An explicit, publicly announced "closure rule" requiring the regulators to promptly resolve troubled institutions before their net worths decline below some low but positive critical level. The critical cutoff value of the capital-to-asset ratio should be sufficiently high so that, in the absence of large-scale fraud and unusually abrupt adverse changes in market values of a diversified portfolio of earning assets and liabilities, no losses are suffered by depositors or the deposit insurance agency. Losses from bank insolvencies are thus restricted to bank shareholders and deposit insurance becomes effectively redundant.
5. Risk-based deposit insurance premiums, both to discourage banks from assuming excessive risk and to prevent less risky banks from cross-subsidizing riskier banks. Because the closure rule should minimize losses to the insurance agency, overall premiums to be charged insured banks would be low and necessary only to cover these small losses and to finance operating costs, including monitoring market values.
6. Market or current value accounting, so that economic values rather than historical or book values are the basis for decisions by bank customers, bank managers, and regulators. This would also make for greater disclosure and transparency and increase the accountability of both banks and their regulators.

Although all six parts of the SEIR scheme contribute to its effectiveness, the key provision is the firm and explicit "closure rule." Indeed, no deposit insurance structure is effective in minimizing the costs from failures unless it includes such a rule. The prompt corrective actions increase the effectiveness of the closure rule by progressively increasing the cost to financially deteriorating banks of "gambling for resurrection" as they approach the closure capital ratio. The program must be compulsory for all banks in order that no banks remain implicitly insured.

The scheme operates more effectively if capital were measured relative to total assets—the leverage ratio—rather than to risk-based assets. This is not because the amount of capital that a bank is required to maintain by the market is not related to its riskiness, but because the necessary information appears to be too difficult to be incorporated accurately in the risk classifications adopted by the regulators. The risk classifications and weights adopted by the regulators to date have been arbitrary, incomplete, insufficiently reflective of the riskiness of the bank as a whole as opposed to individual activities, and modified to pursue political and social objectives. As a result, Elroy Dimson and Paul Marsh (1995) and Michael Williams (1995) demonstrate that

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TABLE 1

SUMMARY OF PROMPT CORRECTIVE ACTION PROVISIONS OF THE FEDERAL DEPOSIT INSURANCE CORPORATION IMPROVEMENT ACT OF 1991

Zone	Mandatory Provisions	Discretionary Provisions	Capital Ratios (percent)		
			Risk Based		Leverage
			Total	Tier 1	Tier 1
1. Well capitalized			>10	>6	>5
2. Adequately capitalized	1. No brokered deposits, except with FDIC approval		>8	>4	>4
3. Undercapitalized	1. Suspend dividends and management fees 2. Require capital restoration plan 3. Restrict asset growth 4. Approval required for acquisitions, branching, and new activities 5. No brokered deposits	1. Order recapitalization 2. Restrict inter-affiliate transactions 3. Restrict deposit interest rates 4. Restrict certain other activities 5. Any other action that would better carry out prompt corrective action	<8	<4	<4

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4. Significantly undercapitalized	1. Same as for Zone 3 2. Order recapitalization[a] 3. Restrict inter-affiliate transactions[a] 4. Restrict deposit interest rates[a] 5. Pay of officers restricted	1. Any Zone 3 discretionary actions 2. Conservatorship or receivership if fails to submit or implement plan or recapitalize pursuant to order 3. Any other Zone 5 provision, if such action is necessary to carry out prompt corrective action	<6	<3	<3
5. Critically undercapitalized	1. Same as for Zone 4 2. Receiver/conservator within 90 days[a] 3. Receiver if still in Zone 5 four quarters after becoming critically undercapitalized 4. Suspend payments on subordinated debt[a] 5. Restrict certain other activities				<2

[a]Not required if primary supervisor determines action would not serve purpose of prompt corrective action or if certain other conditions are met.

SOURCE: Board of Governors of the Federal Reserve System.

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they provide distorted incentives, which differ significantly from those the market imposes, and encourage arbitrage within risk classifications. Capital should also be defined to include all bank liabilities that are subordinated to bank depositors and the deposit insurance agency and are not in a position to run. Thus, bank capital should give full weight to nonperpetual preferred stock and subordinated debt with maturities of, say, one year or longer, as well as to equity.

The benefits of a system of SEIR are substantial. In contrast to most government-provided deposit insurance schemes, this structure is both incentive compatible, so that all involved parties row in the same and appropriate direction, and market oriented, so that regulatory discipline is reinforced by that of de facto as well as de jure uninsured depositors. No institution would be "too big to fail" in terms of protecting uninsured depositors, shareholders, or senior management. By providing a number of triggers for regulatory intervention rather than only one, the progressivity of severity of the sanctions will be more moderate and both the likelihood and credibility of intervention by the regulators increased. Moreover, because losses to the insurance agency are no longer a major concern, banks could be permitted to engage in a wide range of activities, at least with respect to prudential concerns. The permissibility of the activities would be judged on the ability of the regulators to monitor their values accurately and timely for purposes of prompt corrective action and resolution. It follows that more difficult to monitor activities could be permitted banks with higher capital ratios. This flexibility would provide incentives for banks to improve their capital positions and introduce carrots as well as sticks in the structure. Banks would be risking their own private capital rather than that of the insurance agency.

If structured correctly, for any given degree of macroeconomic instability, SEIR should reduce the probability of individual bank failure, the cost of failure to depositors, other bank customers, and the community, and, by reducing if not eliminating depositor losses and the need for depositors to run on their banks, also the likelihood of systemic risk. The greater the macroeconomic instability in a country, the higher would have to be the relevant capital ratios for prompt corrective action and resolution to achieve these objectives. By itself, SEIR is not a substitute for stabilizing macroeconomic policy. Although reducing the likelihood of failure, the scheme does not eliminate failure, only the cost of failure to depositors and other creditors. Thus, the exit of poorly performing banks, which is required in any efficient industry, is not affected. Banks would no longer be unique and different from other firms because of any perceived or actual greater adverse impact of their failure and therefore no longer

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warrant specific public policy concern for prudential reasons. Benston and Kaufman (1996) conclude that restrictions on bank product and geographic powers that may have been imposed for prudential reasons may be removed and banks subject only to those public policies applied to other industries.

Systemic Risk and the Payments System

As noted earlier, banks are closely interconnected not only by depositing funds with each other and lending to and borrowing from each other (interbank balances), but also by making and receiving funds transfers from each other in the process of clearing payments due to or from other banks (interbank transfers). Because such transfers are frequently in very large amounts, are processed almost immediately, and are highly concentrated among a few large participating banks, the impact of defaults is more likely to spread quickly to other banks participating in the clearing process and is considered particularly disruptive as it may cause at least temporary gridlock in the payments system.

Defaults in the payments clearing process can occur when the payment and receipt of funds are not simultaneous, so that funds are disbursed before they are received. As a result, credit is extended by one party to another. In generic modern interbank clearing systems, payment for individual large value transactions may be made to other banks at the time delivery is made, generally electronically by wire transfer, but final settling of net outstanding balances at each participating bank is not made until day-end. Thus, for example, a bank may accept delivery of previously purchased securities, either for themselves or their customers, in midday and pay for them at that time even though it may not have the necessary funds on deposit at the clearing facility at the time. An intraday or daylight overdraft occurs. The bank anticipates having sufficient funds in its account at day-end through scheduled inflows to settle the overdraft, but these inflows are not certain and may not occur. If they do not and represent defaults on obligations from third parties and the resulting losses exceed the bank's capital, the bank in turn will default on its obligations to other banks. Because the same funds may be transferred a number of times among banks before day-end settlement, in case of default, these transfers must be reversed in order to identify who owes whom what. This process is costly, time consuming, and disruptive. Moreover, as described in Bank for International Settlements (1994), Robert Eisenbeis (1995), Flannery (1988), Baer et al. (1991), David Humphrey (1987), George Juncker et al. (1991), Robert Parry (1996), Heidi

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Richards (1995), and Bruce Summers (1994), because the unwinding may result in losses that could cause other banks along the chain to default, so that losses cascade through the banking system, the payments system is commonly viewed as a source of systemic risk. A contrary view is described in Angelini, Mariesca, and Russo (1996).

To reduce the severity of such disruptions from default, some clearing systems guarantee or provide finality for each individual funds transfer as it occurs. The costs of later, day-end settlement defaults are then borne by the sponsors of the clearing facility (house). Such finality is more credible when the facility is operated by a government agency, e.g., the central bank, than by private entities, e.g., private banks. In the United States, an example of the first type of facility is Fedwire, operated by the Federal Reserve, and of the second type is CHIPS, operated by large New York City banks. Clearings on Fedwire are thus free of systemic risk.

Except for larger and more concentrated exposures, the credit risk assumed by banks in the clearing process is little different from that assumed by them in any transaction. Thus, basically the same techniques for reducing this exposure apply. The bank needs to know and monitor its counterparties, require margin when necessary, impose maximum loan limits, and charge a commensurately high interest rate on any credit extension. The bank's own risk of default is reduced by maintaining sufficient capital in light of its overdraft exposures. The bank may also delegate some of these decisions to the clearing house.

Until recently, the Federal Reserve did little to encourage banks to be greatly concerned about daylight overdrafts in their use of Fedwire. Because all payments were guaranteed by the Fed when made, the risk of default was borne only by the Fed. The Fed neither charged for daylight overdrafts nor applied bank limits on their use. As a result, Richards (1995) shows that the volume rose rapidly increasing the risk exposure to the Fed and, indirectly, the taxpayers. Since the early 1990s, the Fed has both charged for and limited the use of these overdrafts, but it has been reluctant to impose market-based charges for fear of losing business to competing payments systems. Moreover, David Mengle (1995) believes that the Fed may have provided a perception that it had spread the safety net under the payments system broadly by implying that it would assist banks experiencing liquidity problems on private clearing systems. In fact, as described in Eisenbeis (1995), the Fed provided such assistance in 1985 to the Bank of New York when it suffered a computer breakdown in its securities clearing operations and experienced a large deficit in its reserve balance. Thus, similar to the government guarantees on bank deposits, as structured, the Federal Reserve guarantees on pay-

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ments system transfers in the United States appear to encourage risk taking by banks.

Ironically, the Federal Reserve views itself as a retarder rather than as an engine of risk taking in the payments system. Parry (1995: 2–3), president of the Federal Reserve Bank of San Francisco, recently argued that

> central banks do have responsibilities for reducing settlement risk. . . .settlement risk is a source of systemic risk. . . .Central banks need to worry about systemic risk because the private sector simply doesn't have the incentives to address this risk adequately. In fact, that's the very genesis of central banks' traditional oversight role in payments system issues. . . .There's a second role for central banks in reducing settlement risk. It stems from the unique advantage central banks have in being able to provide irrevocable, final settlement through the use of central bank money.

Similar to losses from bank failures for other reasons, the probability of a default by a bank and the magnitude of any resulting loss to other banks and parties from the payment system is reduced greatly if not eliminated by an appropriately designed SEIR structure. But, because of the large amounts, quick transfers, and high concentrations, additional precautions may be warranted to protect both the payments system itself and banks from defaults in the clearing process. The Bank for International Settlements (1994) notes that this may be done for large value transfers by permitting only simultaneous payments and receipts, or payments only in "good funds" against either other such payments, e.g., in foreign exchange trading, or delivery, e.g., in securities trading. This would eliminate the need for net settlement at day-end. Because almost all clearing facilities now have the ability to monitor in real time, such gross clearings for large value transfers are likely to be neither excessively costly nor disruptive relative either to the cost and disruption from defaults or to the long-run cost of providing an inappropriately designed safety net. Alternatively, Benston (1994) argues that market determined intraday interest rates may be charged for daylight overdrafts, maximum loan limits established for each bank, collateral required against debit positions, and participants in the clearing process subject to minimum capital requirements determined by the clearing house. To the extent the operator of the clearing facility is the government, the principal-agent problems discussed earlier are likely to exist so that appropriate measures to deter private defaults may not be imposed and resulting losses socialized. This suggests that economic welfare is enhanced if the clearing facility is private and its sponsoring banks subject to the provisions of SEIR.

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A similar but more difficult problem to solve arises if payments are settled in different clearing facilities when settlement day-end is not at the same time at each facility. This is particularly likely for clearing facilities in different countries in different time zones. This problem was responsible for losses to some U.S. banks in 1974 when the Herstatt Bank in Germany failed and was closed by the German authorities after payment was made to it by U.S. banks at day-end in marks on the German clearing house but before it could make payments to U.S. banks at day-end in dollars in New York, which was later the same day. Because this problem cuts across different national sovereignties and thus laws, its solution is more difficult and requires coordination among the clearing facilities and respective governments. But as international markets evolve toward 24-hour operations, clearing in only good funds becomes increasingly feasible. Indeed, Philip Gawith (1996) and George Graham (1996a, 1996b) report that real time gross settlement is the solution recently proposed by a number of the world's largest banks and already activated on the London Clearing House Automated Payments System, or CHAPS.

Conclusion

The evidence suggests that banks fail. But so do other firms. Bank failures are costly to their owners, customers, and some third parties. But so are the failures of other firms. To the extent that failures reflect market forces, public policies to prevent exit harm other economic agents, such as competitors and those who will benefit from entry, including consumers of banking services. Nevertheless, bank failures are widely perceived to be more damaging to the economy because of the belief that they are more likely to spill over to other banks and beyond. Thus, almost all countries have imposed special prudential regulations on banks to prevent or mitigate such adverse effects.

This paper argues that these policies (both regulations and institutions) have frequently been incentive incompatible and counterproductive and have unintentionally introduced both moral hazard behavior by the banks and principal-agent problems by the regulators that have intensified the risk and costs of banking breakdowns. In the absence of such anti-systemic risk regulations, the greater fragility of banks did not often translate into greater failures nor did the payments system necessarily introduce greater risk for the banks. Indeed, the two periods of by far the largest number and greatest cost of bank failures in U.S. history occurred after the introduction of policies intended specifically to reduce cascading failures. The first occurred in 1929 and ended in 1933, two decades after the introduction of the

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Federal Reserve System. The second occurred in the 1980s, 50 years after the introduction of the FDIC to supplement the Fed. Moreover, the average annual rate of bank failures was somewhat greater after the introduction of the safety net in 1914 than before and the failure of large banks occurred only in the 1980s. In contrast, the average failure rate for nonbank firms decreased significantly. This suggests that bank instability is more a regulatory phenomenon than a market phenomenon. As Schwartz (1995) has noted, omitting the government as a cause of instability in banking in a play about systemic risk is like omitting the Prince of Denmark from the first act of *Hamlet*.

Although systemic risk may exist without government regulation, on net, the probability of instability occurring in banking and the intensity of any resulting damage are likely to be greatly increased by some government policies adopted in the name of preventing systemic risk. This conclusion is not unique to banking. For example, modifying an analogy developed by Robert Merton (1995), just as governments may reduce the monetary damage from floods by providing information about water levels to threatened home owners, they may simultaneously increase the damage by providing flood insurance and encouraging the home owners to build and rebuild in flood plains. The latter adverse effect is likely to dominate the former beneficial effect. A similar conclusion was reached by the late Fischer Black (1995: 8), who noted:

> When you hear the government talking about systemic risk, hold on to your wallet! It means they want you to pay more taxes to pay for more regulations, which are likely to create systemic risk by interfering with private contracting. . . .In sum, when you think about systemic risks, you'll be close to the truth if you think of the government as causing them rather than protecting us from them.

Governments appear to face a tradeoff between two types of banking problems—potential systemic risk from the failure of one or more banks and non-systemic bank failures from excessive risk-taking and inadequate regulatory discipline. The first problem may be solved by introducing a safety net in the form of government deposit insurance and having the central bank act as lender of last resort. But, if poorly designed or implemented, this solution is likely to increase the fragility of banks and exacerbate the second problem. Thus, governments appear to have a no-win choice. But the evidence, at least for the United States, is quite clear. The cost of systemic risk before the introduction of the safety net under banking in 1914 was far smaller than the cost of bank failures since then.

The counterproductive prudential policies have been imposed more in response to perceptions of systemic risk and "horror stories"

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in the popular press than in response to empirical evidence by public policymakers, who were responding to public outcries and were highly risk-averse. Similar to nuclear plant accidents, even if the probability of systemic risk in banking was very low, if it ever did occur, the expected losses would be very great, and reflect poorly on government officials and regulators. Moreover, through time, the regulators have developed a vested interest in maintaining and even expanding prudential regulations designed to combat systemic risk as they have become aware of the public prestige and power these regulations bestowed on them as protectors of society from financial collapse. In recent years, regulators have been among the most vociferous expositors and prophets of the dangers of systemic risk.[13]

[13]For example, John LaWare (1991: 34), a former governor of the Federal Reserve System, testified before Congress when he was governor that

> it is systemic risk that failed to be controlled and stopped at the inception that is a nightmare condition, unfair to everybody. The only analogy that I can think of for the failure of a major international institution of great size is a meltdown of a nuclear generating plant like Chernobyl.
>
> The ramifications of that kind of failure are so broad and happen with such lightning speed that you cannot after the fact control them. It runs the risk of bringing down other banks, corporations, disrupting markets, bringing down investment banks along with it . . . . We are talking about the failure that could disrupt the whole system.

Similarly, C.T. Conover (1984: 288), who was the Comptroller of the Currency at the time of the Continental Illinois National Bank failure in 1984, testified in Congress at the time that

> had Continental failed and been treated in a way in which depositors and creditors were not made whole, we could very well have seen a national, if not an international, financial crisis, the dimensions of which were difficult to imagine. None of us wanted to find out.

Moreover, in 1993, nearly 10 years after the failure of the Continental Bank, Governor LaWare (1993: 96) was still arguing that the bank's failure would have led to the insolvency of

> several hundred [banks]. . .many large companies and banks, both in the United States and in foreign countries, would have lost large amounts as their. . .claims were not honored. . . .[This might] have created a crisis of confidence. . .[and] would have seriously destabilized the entire banking system.

In fact, as was known at the time, had the Continental been resolved on a timely basis, most likely through sale or merger, the loss would have been no greater than 5 percent of its total assets. This is about the same loss as the FDIC suffered when it finally resolved the institution in the early 1990s, after protecting all depositors and creditors.

LaWare argued this despite the results of a U.S. Congressional study (1984) which estimated that if Continental's loss had been as large as 60 cents on the dollar, more than 10 times either the estimated or actual loss, only 27 of the 2,299 banks with exposures to the Continental would have suffered uninsured losses in excess of their capital and become insolvent. These losses would have totaled only $137 million. Another 56 banks would have suffered losses equal to between 50 and 100 percent of their capital in an amount totaling $237 million. If Continental's losses were 10 cents on the dollar, twice the actual amount, not one bank would have suffered losses greater than its capital and only two banks would

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The best protection against widespread bank failures and systemic risk is macroeconomic policies that achieve stability and avoid price bubbles that leave banks highly vulnerable to failure. But since the success of such policies is highly questionable, backup prudential policy is desirable. This paper argues that it is possible to reduce both the likelihood and costs of future bank failures as well as any resulting systemic problems without suffering the undesirable side-effects of moral hazard and agency problems that plague many prudential policies. This result can be achieved by introducing an effective system of structured early intervention and resolution (SEIR)—a system that is both incentive compatible and market oriented. Under SEIR, bank failures would be reduced but not eliminated, so that inefficient institutions can exit the industry.

The key feature of the SEIR scheme is an explicit and enforced "closure rule" that resolves banks before their own capital is fully depleted and thereby effectively restricts losses only to shareholders. Explicit full deposit insurance is provided for smaller accounts to prevent systemic risk, but becomes effectively redundant. Because uninsured depositors suffer only small if any losses in bank insolvencies, the major transmission process of systemic risk is not activated and failures of individual banks will not spill over to others. Bank runs, even on individual banks, are far less likely than in a system without a closure rule.

A system of SEIR, although in weakened form, has been included in the United States in the prompt corrective action and least-cost resolution provisions of FDICIA of 1991. Whether it will prevent repeats of the bank failures of the and 1980s, for the same degree of macroeconomic instability, depends on the ability and will of the regulators to enforce the intent of those provisions.

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have suffered losses between 50 and 100 percent of their capital, for a total loss of only $1 million. Systemic risk does not appear to have been a very likely outcome. LaWare's statement represents more "scare talk" and bluster than fact and objective analysis.

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Is Free Banking More Prone to Bank Failures Than Regulated Banking?

Kam Hon Chu

Bankers, economists, and regulators generally accept that banks are special and that bank runs or failures are costly to the economy; banking stability is therefore afforded the utmost importance. This paper investigates empirically the relative stability of three different banking regimes—a free banking system, a regulated banking system, and a regulated one with the presence of a flat-premium deposit insurance scheme—for the period 1935–64. Those regimes are respectively represented by the Hong Kong, Canadian, and U.S. banking systems. A remarkable fact is that there were no bank failures in Hong Kong or Canada during the period under study.[1]

The paper begins with a summary of the major views on the relations between banking regulations, deposit insurance, and bank failures. A brief description of the institutional and economic backgrounds of the three banking systems during the period under study follows. Finally, the empirical results comparing the relative stability of the alternative banking regimes are presented.

Regulations, Deposit Insurance, and Bank Failures

The traditional, dominant view is that free or unregulated banking is inherently unstable because of market failures arising from such

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[1]The bank failure rate is used as a quantitative measure of banking instability. The higher the bank failure rate, the more unstable is the banking system. This assumption ignores other aspects of instability of the economy such as (hyper)inflation resulting from adopting a particular monetary regime. Obviously, there is no unique objective indicator measuring the different facets of instability.

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factors as externalities, natural monopolies, and information asymmetry. Free banking causes counterfeiting, wildcat banking, fraudulent banking, over-issue of banknotes and overexpansion by banks. Free banks therefore are prone to failures and lead to systemic banking instability. Economic and non-economic reasons have been given to justify banking regulations—such as protection of small depositors, maintenance of monetary stability, protection of the payments system, assurance of safety and soundness of financial institutions, avoidance or limitation of the effects of failed institutions, and encouragement of efficiency and competition in the financial system.[2] Bank failures in Indiana, Wisconsin, and Minnesota during the free banking era (1837–1865) are cited as prima facie evidence of the instability of free banking.

This conventional view has come under increased scrutiny since the 1970s. Benjamin Klein (1974), F. A. Hayek ([1978] 1990), Lawrence H. White (1984), Roland Vaubel (1985), George Selgin (1988), David Glasner (1989), and others have provided a theoretical basis and offered historical evidence for the soundness of a free banking system. One of the major arguments is that competition in the supply of money forces banks to maintain either their brand names or convertibility of their liabilities (banknotes or deposits) into specie or real commodities, which in turn prevents banks from over-issuing money. In contrast, a self-correcting mechanism does not exist under monopolized supply of money by the government. Therefore, free banking is more stable than central banking.

Empirical studies of the U.S. free banking era by Hugh Rockoff (1974, 1975) and by Arthur Rolnick and Warren Weber (1983, 1984, 1988) show that that era was not as chaotic as commonly thought. Lawrence H. White (1984) uses the Scottish free banking era as historical evidence of the success of free banking in practice. Other studies of free banking outside the United States—e.g., those by Weber (1990), Eugene White (1990), Andrew Economopoulos (1988, 1990), and Kevin Dowd (1992)—also support the stability of free banking.

Some economists, though not necessarily advocates of free banking, argue that banking regulations (such as interest-rate ceilings, restrictions on loans and investments, and required reserves) can be a source of instability. The major ways in which regulations affect the stability of financial institutions are well summarized by George Benston (1991). First, regulations constrain banks' diversification by limiting banks' portfolio choices or by restricting branching, thus reducing the flexibil-

[2]See, for example, Cooper and Fraser (1986), Goodhart (1988, 1989), and Spong (1992).

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ity of banks to accommodate unanticipated shocks. Second, as implicit taxes, regulations reduce banks' profitability. Third, regulations often create a moral hazard problem by encouraging risk taking. Fourth, while it may be the intention of the regulatory authorities to promote banking stability by interventions through monitoring, supervising, and preventing fraud and grossly incompetent management, it is usually the case that supervision is inadequate.[3]

Before the recent deposit insurance crisis in the United States started to surface, most economists had a strong faith in deposit insurance.[4] Information and confidence externalities in the banking sector were believed to justify the setup of a deposit insurance scheme. The steep decline in the bank failure rate from 28.16 percent in 1933 to 0.37 percent after the establishment of the Federal Deposit Insurance Corporation (FDIC) in 1934 was regarded as evidence of the effectiveness of deposit insurance in stabilizing the banking industry.[5] Formal theoretical models (e.g., Diamond and Dybvig 1983) have also been developed to justify deposit insurance.

While deposit insurance reduces or eliminates the systemic risk due to contagious bank runs, it also induces a moral hazard problem by encouraging banks to take excess risk (Kane 1985). Moreover, it is not obvious if the systemic risk is reduced when the deposit insurance fund is insufficient to cover depositors' losses. For instance, there were runs in 1985 on the Home State Savings Bank and 70 other thrifts insured by the Ohio Deposit Guarantee Fund following Home State's reported loan loss of $140 million, which exceeded the fund's $136 million in reserves.[6]

The Hong Kong, Canadian, and U.S. Banking Systems, 1935–64

During the period 1935–64, the Hong Kong banking system was virtually unregulated, whereas the Canadian system was regulated,

[3]It should be stressed that the inadequacy of supervision, in Benston's opinion, refers only to the U.S. experience. It is not necessarily the case in other countries.

[4]See, for example, Friedman and Schwartz (1963: 434): "Federal insurance of bank deposits was the most important structural change in the banking system to result from the 1933 panic, and, indeed, in our view, the structural change most conducive to monetary stability."

[5]A recent econometric study by Cottrell, Lawlor and Wood (1993) finds that, using the data on U.S. bank failures for the period 1892 to 1989 and controlling for likely economic shocks to the financial systems, FDIC (or variables correlated with that insurance) decreased bank failures while state insurance systems appear to have increased bank failures.

[6]Two months after the runs in Ohio, similar runs occurred in Maryland. While it can be argued that such runs might not have taken place if the deposit insurance funds were run by state governments instead of private companies, the state governments would have been more credible insurers only if they had been perceived as ready and able to finance (by

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and the U.S. system was regulated and subject to federal deposit insurance. Banking was not completely free in Hong Kong because the right to issue banknotes was restricted to only three private commercial banks, whereas the supply of coins and notes of small denominations was monopolized by the Hong Kong government.[7] Nonetheless, there was free trade in banking in the sense that supplies of deposits and loans were competitive and largely unrestricted. Furthermore, Hong Kong had no deposit insurance and no central bank; neither a discount window nor an official lender of last resort existed. At the same time, banking regulations were very lenient. The first Banking Ordinance was passed in 1948. But except an annual licence fee of HK$5,000, banks were not subject to any restrictions, such as minimum capital-asset ratios, reserve ratios, or liquidity ratios. More stringent banking regulations were not imposed until the Banking Ordinance of 1964 was passed on October 16, 1964. As banking business was not precisely defined in Hong Kong before this Ordinance, all financial institutions reported as "banks" in the official statistics are included in our sample.[8]

The downtrend in the number of banks in Hong Kong in the 1948–58 period (see Table 1) was caused by both economic and noneconomic factors.[9] Nonetheless, this downtrend did not result in any reported losses to depositors or turmoil to the financial system, so banks that left the industry are not counted as failed banks in this study. Although there were no bank failures during this period, there was a short-lived run on the Liu Chong Hing Bank, a medium-sized local bank, in June 1961, partly due to the liquidity squeeze arising from the oversubscription of rights and new issues on the local stock market and unfavorable clearings suffered by small banks. It ended after the Liu Chong Hing Bank had reportedly used its real estate holdings on a purely commercial basis to secure advances from the two largest note-issuing banks (Jao 1974: 238–40).

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borrowing or taxing) whatever amount was necessary to replenish the insurance fund. The same is true of federal deposit insurance.

[7]The three private note-issuing banks were the Hong Kong and Shanghai Banking Corporation, the Chartered Bank (now known as the Standard Chartered Bank), and the Mercantile Bank.

[8]Official statistics on the number of banks in Hong Kong were not available until the first Banking Ordinance was passed in 1948. However, this does not affect our empirical results qualitatively because there were no bank failures in Hong Kong resulting in losses to depositors during the period under study.

[9]First, a number of marginal banks were weeded out by the licensing and annual license fee requirements of the Banking Ordinance. Second, for noneconomic reasons, some banks ceased their operations or were reorganized following the communist takeover of mainland China. Third, some banks closed because of the U.S. embargo on trade with China during the Korean War and increasing competition in the banking industry.

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The Canadian banking system during the period under study was a regulated one without deposit insurance as the Canadian Deposit Insurance Corporation (CDIC) was not established until 1967. It had more stringent regulations than its Hong Kong counterpart. Banks in Canada here refer to the Schedule A banks or the so-called chartered banks. During this period there was neither a bank failure nor a run (see Table 1).[10]

The U.S. banking regulations were more complicated and stringent than those in Canada. In addition, the Federal Deposit Insurance Corporation (FDIC)—a flat-rate deposit insurance system—had been set up in 1934. Because of the differences, U.S. banks in this study are limited to commercial banks insured by the FDIC. Other depository institutions such as noninsured commercial banks, mutual savings banks, and S&Ls are excluded—either because their deposits are not insured or because their business activities differ from those of commercial banks.[11] Failed banks here refers to insured commercial banks that were closed because of insolvency (i.e., because of losses to liability holders or insurers). The bank failure rate for a particular year is calculated as the number of "failed" banks in that year as a percentage of the average number of banks in that year.

Economic downturns are a major factor highly related to bank failures.[12] However, in terms of economic fluctuations, the period under study is one of the most stable in this century. The world economy enjoyed decades of steady growth and stability in prices and interest rates. There were no dramatic events such as the Great Depression and the oil crises. Both Hong Kong and Canada were, and still are, major trading partners of the United States, and the business cycles of the three economies moved closely together. For the period under study, Hong Kong and Canada registered higher average growth rates than the United States. For 1935–64, the U.S. economy grew on average at 4.7 percent a year in real terms, while the real economic growth of Canada was higher, at 5.5 percent. Official

[10]As a matter of fact, there had been no bank failures in Canada since the Home Bank of Canada failed in 1923. Bank failure did not occur until 1985, when both the Northland Bank and the Canadian Commercial Bank failed.

[11]Mutual savings banks were also insured by the FDIC but they accounted for about a mere 2 percent of the total number of depository institutions insured by the FDIC. Including them would not change qualitatively our empirical findings.

[12]Benston et al. (1986: 59) examine the American banking history and find that "between 1870 and 1919 there were six non-war-related downturns in industrial production. Each was accompanied by an increase in the number of bank failures. In the period there were also six downturns in the stock market. Again, each was accompanied by an increase in bank failures. Thus, major increases in overall bank failures and major national recessions appear closely related."

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TABLE 1

NUMBER OF BANKS AND BANK FAILURES, 1934–66

	Hong Kong			Canada			United States		
Year	Banks	Failures	Rate (%)	Banks	Failures	Rate (%)	Banks	Failures	Rate (%)
1934	36	0	0	10	0	0	13915	9	—
1935	38	0	0	10	0	0	14179	26	0.19
1936	39	0	0	10	0	0	14065	69	0.49
1937	40	0	0	10	0	0	13887	76	0.54
1938	44	0	0	10	0	0	13727	73	0.53
1939	44	0	0	10	0	0	13572	60	0.44
1940	44	0	0	10	0	0	13483	43	0.32
1941	n.a.	0	0	10	0	0	13426	14	0.10
1942	n.a.	0	0	10	0	0	13403	20	0.15
1943	n.a.	0	0	10	0	0	13302	5	0.04
1944	n.a.	0	0	10	0	0	12269	2	0.02
1945	n.a.	0	0	10	0	0	13282	1	0.01
1946	n.a.	0	0	10	0	0	13335	1	0.01
1947	133	0	0	10	0	0	13391	5	0.04
1948	143	0	0	10	0	0	13420	3	0.02
1949	138	0	0	10	0	0	13423	5	0.04
1950	133	0	0	10	0	0	13449	4	0.03
1951	125	0	0	10	0	0	13451	2	0.01
1952	111	0	0	10	0	0	13450	3	0.02

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1953	101	0	0	10	0	0	13435	4	0.03
1954	94	0	0	11	0	0	13400	2	0.01
1955	91	0	0	11	0	0	13287	5	0.04
1956	86	0	0	10	0	0	13229	2	0.02
1957	83	0	0	9	0	0	13211	2	0.02
1958	81	0	0	9	0	0	13144	4	0.03
1959	82	0	0	9	0	0	13097	3	0.02
1960	86	0	0	9	0	0	13147	1	0.01
1961	85	0	0	9	0	0	13136	5	0.04
1962	92	0	0	8	0	0	13111	1	0.01
1963	87	0	0	8	0	0	13196	2	0.02
1964	88	0	0	8	0	0	13401	7	0.05
1965	86	2	2.30	8	0	0	13535	5	0.04
1966	76	1	1.23	8	0	0	13559	7	0.05

NOTE: The bank failure rate for a particular year is calculated as the number of "failed" banks in that year as a percentage of the average number of banks in that year. To illustrate, the average number of banks in Hong Kong in 1965 is (88 + 86) ÷ 2 = 87 (because the official figures are year-end figures) and the bank failure rate is therefore equal to 2 ÷ 87 × 100 = 2.30 percent.

SOURCES: (1) Hong Kong: Data for 1948–66 are from *Hong Kong Annual Report*, Hong Kong Government, various issues; *Banker's Yearbook*, Chinese Bankers Association, various issues; and Jao (1974). The figure for 1947 is based on the total number of banks that obtained their licenses when the first Banking Ordinance was passed in January 1948. The total number of banks in 1949 is an interpolation (the official statistic is unavailable). Data before World War II are estimated from available literature. (2) Canada: Neufeld (1972). (3) United States: *Historical Statistics of the United States: Colonial Times to 1970 Part II*, U.S. Department of Commerce.

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real growth rates of the Hong Kong economy are not available for the same period. Measured in nominal terms, Hong Kong's economy grew by 11.3 percent a year on average for the period 1948–64. Deflated by the retail price index, the available official price index, the average "real" growth rate is slightly lower at 9.3 percent.

Could the occurrence of bank failures in the United States during this period simply be due to economic growth lower than that of Canada or Hong Kong? An examination of the data indicates that this is highly unlikely. First, bank failures occurred in the United States notwithstanding good or bad years (see Table 1). Second, the U.S. economy experienced downturns in 1938, 1945–47, 1954, and 1958, but the bank failure rates for those years (except 1938) are not the highest among the U.S. bank failure rates within the sample, not to mention the fact that they are not significantly different from the other observations.[13] On the other hand, the economic downturns in Canada in 1946–47 and 1954 did not result in any bank failures. Similarly, there were no bank failures in Hong Kong following its 7 percent (in nominal terms) negative economic growth in 1952.

The Relative Stability of the Three Banking Regimes

The fact that there were no bank failures in both Canada and Hong Kong during 1935–64 while the United States experienced bank failures each year suggests the banking systems are not equally failure-prone. This hypothesis is supported by our empirical results based on the Friedman test.[14] The computed value of the statistic is 60, greater than the critical values of 5.99 and 9.21 at the 5 percent and 1 percent significance levels respectively. In other words, the U.S. bank failure rates were more than randomly higher than failure rates in Canada and Hong Kong.

It is possible that, since the Friedman test is based on ranks, the United States is ranked first simply because of its large number of banks. To examine that possibility, an alternative test is implemented. Assume that bank failures are binomially distributed such that each

[13]A statistical test indicates that the bank failure rates within each regulatory regime are not significantly different from each other. This result implies that the economic contractions during the sampling period were so mild that they did not have a drastic impact on bank failures.

[14]The Friedman test is a distribution-free test based on ranks (see Neave and Worthington 1988). It is applied because the bank failure rates are not normally distributed and also because of its appropriateness to the problem—we are examining if there is evidence of real differences between regulatory regimes over the period under study.

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bank has the same probability to fail each year. For 1935–64, there are a total of 401,308 draws for the U.S. sample, of which 450 failed.[15] From these observations, the probability of bank failure is estimated to be 1.12×10^{-3}. Under the null hypothesis that the U.S. and Hong Kong banking systems were equally failure-prone, the likelihood of obtaining no bank failure in a sample of 2,088 observations for Hong Kong is found to be about 0.10.[16] This means that the null hypothesis cannot be rejected at the conventional 5 percent significance level but can be rejected at the 10 percent level. The same procedures are repeated to compare the American and Canadian banking systems, and the probability of obtaining no bank failure among the 291 Canadian observations is 0.72, indicating that both banking systems are equally failure-prone. Because of different underlying assumptions, the two sets of empirical results are somewhat different. Nevertheless, both indicate that *free or unregulated banking is not more prone to bank failures than regulated banking*. On the contrary, if we are willing to accept a 10 percent significance level for our hypothesis testing, the test based on the binomial distribution suggests that the Hong Kong banking system was more stable than the U.S. banking system in terms of bank failures.

Opponents of free banking can argue that the Banking Ordinance of 1964 came too late—a grace period of two years was allowed for banks to meet the various requirements—to prevent and moderate the 1965 crisis.[17] During the grace period, three banks failed: the Ming Tak Bank and the Canton Trust and Commercial Bank in early 1965, and the Yau Yue Bank in 1966. The failures of the first two banks also triggered a banking crisis, which saw runs on several local banks (Jao 1974: 246–50). To see how sensitive our empirical results are to the 1965 banking crisis, the same empirical procedures are

[15]The figures are respectively the sum of the total number of banks each year over the entire sampling period and the total number of bank failures during the same period.

[16]This figure is calculated excluding the years 1941–46. The years 1941–45 are excluded because of World War II; normal banking business was suspended during the Japanese occupation. The rapid postwar economic recovery saw the establishment of many new banks and the introduction of the first Banking Ordinance. There are no official statistics for the total number of banks in 1946 and 1947. The figure for 1947 in this study is based on the fact that initially 133 banking licenses were granted under the first Banking Ordinance, passed on January 29, 1948. If the 1947 figure is omitted, the probability of observing no bank failure will be marginally higher, at 0.11.

[17]On the other hand, the 1964 Banking Ordinance was based on the Tomkins Report completed in April 1962 to review the banking system following the run on the Liu Chong Hing Bank a year earlier. The recommendations of the report were criticized by the local financial circles as unsuitable for Hong Kong, because they were based on the English blueprint and put small local banks into a competitive disadvantage against the large foreign banks.

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repeated for the extended period 1935–66. Our empirical findings for the Friedman test do not change qualitatively. The computed value for the test statistic is 55.43, substantially higher than the critical values of 5.99 and 9.21 at the 5 percent and 1 percent significance levels respectively, indicating that the failure rates of the three banking systems are not equal.

The computed statistic for a comparison between the U.S. and Hong Kong banking systems, using Dunn's multiple comparison method, is 5.38 while that for the U.S. and Canadian systems is 4.63. Both figures are greater than the critical values of 2.64 and 3.02 at the 5 percent and 1 percent levels respectively. In other words, the United States still had a higher average bank failure rate than either Hong Kong or Canada. While there were three bank failures in Hong Kong, the failure rate was not statistically different from the Canadian rate because the correspondent statistic is 0.5. For the test based on the binomial distribution, the likelihood of obtaining the Hong Kong realizations from the U.S. population is 0.21 while that for Canada is 0.72. Thus, we cannot reject the null hypothesis that the three banking systems are equally likely to fail. As in the previous case, there is no evidence that free banking is more prone to bank failures than regulated banking.

The occurrence of bank runs is often associated with banking instability. The 1965 banking crisis raises the question whether free banking is more prone to bank runs. To free-banking proponents, the 1965 bank runs would not have occurred if the affected banks had the right to issue banknotes. Although a bank run may produce a relatively small cost, in both private and social terms, by increasing uncertainty and the shoe-leather cost of transferring funds, it can be a means to discipline banks and maintain good banking practice. So long as the run is not on the entire banking system, it is not necessarily as bad or unstable as most people perceive (Kaufman 1988). Available official monetary statistics revealed that customer deposits of the Hong Kong banking industry were HK$6,377 million at the end of March 1965, down by 1.76 percent from HK$6,491 million at the end of 1964. The decline was partly due to deposit losses resulting from the bank failures. Deposit growth resumed after March 1965 and reached HK$ 7,250 million by the end of 1965, an increase of 11.69 percent from a year earlier. Available bank balance sheet data reflect that over the year there was a redistribution of deposits within the banking system rather than a run on the entire system.

The empirical results indicate that free or unregulated banking is not more prone to bank failures than regulated banking. The American experience that the mere existence of regulations does not guarantee

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banking stability is also shared by Hong Kong. Before the Banking Ordinances of 1948 and 1964, the Hong Kong banking industry was virtually unregulated but governed by common law originating from Britain, which covered the contractual and tort relations between the customer and the bank, but not between the government and the banking industry. Ironically, the Hong Kong banking system enjoyed a long period of stability in the past despite the fact that it was largely unregulated. For the period 1864–1933, the Hong Kong banking system was more stable than its Canadian and American counterparts. There had not been any documented and reported bank failures resulting in losses to depositors and financial crises since the collapse of the Oriental Banking Corporation in 1884.[18] The year 1864 marked the end of the U.S. free banking era as a result of the National Banking Act of 1863. On the other hand, the Canadian federal government was granted the exclusive jurisdiction over currency and banking after Confederation in 1867. The Bank Act of 1871, the first permanent legislation governing banking in Canada, was passed by the new federal government. The banking regulations failed to prevent bank failures. The 1965 banking crisis in Hong Kong also shows that regulations are no guarantee for financial stability. Between 1967 and 1981, the Banking Ordinance had been amended 19 times to strengthen banking regulations. Yet regulations failed to prevent the 1982–86 banking crisis, during which a total of seven commercial banks experienced financial difficulties, and they were taken over by either the Hong Kong government or other financial institutions.[19]

Among the many factors contributing to banking stability, an argument that is based on market power and the value of bank charters deserves attention. As Michael Keeley (1990) argues, increasing competition causes the values of bank charters to decline, which in turn causes banks to increase their asset risk. During 1935–80, the various regulatory restrictions protected U.S. banks from competition and made bank charters valuable, which counterbalanced banks' incentives for excessive risk-taking due to fixed-rate deposit insurance. Similarly, as Jack Carr, Frank Mathewson, and N.C. Quigley (1995) argue, one of the factors contributing to the stability of the Canadian banking system during the 1924–66 period was that substantial barriers to entry made bank charters valuable, which in turn provided incentives for bank managers and shareholders to avoid risky policies. The increases in the number of failures of depository institutions in both Canada and the United States in the 1980s can be attributed partially

[18]Its failure was due to the failure of coffee crop in Ceylon (Sri Lanka) (King 1990: 16).
[19]For an analysis of the banking crisis in Hong Kong during 1982–86, see Jao (1987).

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to the combined effects of increasing competition arising from banking deregulation and the fixed-rate deposit insurance systems: the former diminished the values of bank charters whereas the latter created a moral hazard for excessive risk-taking.

The bank-charter-value hypothesis can also be a plausible explanation for the long period of free banking stability in Hong Kong. Although banks in Hong Kong were not protected from competition by any explicit regulatory barriers, there were fewer distortions due to government regulations and interventions when banks made their decisions on the tradeoff between risk and expected return. Given bankruptcy costs and monopoly rents from market power, banks had an incentive not to risk failure. There were not many banks in the industry until the influx of banks from China in the 1930s due to the Sino-Japanese War. This suggests that banks enjoyed a certain degree of market power. On the other hand, the banking crises of 1965 and 1982–86 occurred when competition was known to be fierce.

Conclusion

The empirical results of this paper indicate that free banking is not more prone to bank failures than regulated banking. This finding is robust with respect to the statistical tests and the sampling periods used in the study. The results based on the binomial distribution of bank failures do not show any evidence that free banking is more failure prone than regulated banking. On the contrary, the low probability of obtaining the Hong Kong realizations suggests that the Hong Kong banking system was more stable than its American counterpart during 1935–64. This finding is reinforced by the results of the distribution-free tests, which show that the U.S. bank failure rate was significantly higher, in a statistical sense, than its counterparts in Canada and Hong Kong. This result is consistent with the moral hazard argument that non-risk-rated deposit insurance induces banks toward excessive risk taking and therefore results in more bank failures. The moral hazard hypothesis is also supported by the empirical results of Richard Grossman (1992).[20] The fact that Canada had no bank failures and runs at all during the period under study seems to suggest that regulations are necessary and desirable to stabilize a banking system. This policy recommendation, however, should be made with qualifications. First, in the statistical sense, our empirical results show that free banking is not more prone to bank failures than regulated banking. Moreover,

[20]Carr and Mathewson (1992) examine the impacts of the Canadian Deposit Insurance Corporation on Canadian financial institutions and also find similar results.

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the finding that the American banking system had a higher bank failure rate than the Canadian system, though both were regulated, is consistent with Benston's allegation that the U.S. regulatory authorities were not adequate in preventing bank failures. That the existence of regulations does not necessarily stabilize the banking industry is also supported by the Hong Kong experience.

However, the fact that there were no bank failures and runs in Canada during 1923–66 is hardly sufficient for a conclusion that free banking is the optimal banking system. After all, this study has looked into only one aspect of monetary stability—bank failures. Other aspects, such as price stability and the efficiency of the banking system in terms of intermediation and promoting economic growth, need to be examined and considered in the process of banking and monetary reform. Nevertheless, this study is another piece of evidence to show that free banking is not as unstable as most economists believe. If a free banking system is not more prone to bank failures than other banking systems, it can be an effective alternative to banking reform. Regulatory authorities, therefore, should not assume that more regulations naturally translate into fewer bank failures.

Government regulations are not necessarily more effective and efficient than self-regulation. Furthermore, when government regulations are imposed, a distinction between economic regulation and health-safety-environment regulation should be made.[21]

Regulations are costly and distortionary; they may not necessarily achieve the goal of stabilizing the banking system, as evidenced by the U.S. experience. To achieve the goal, appropriate regulations need to be imposed, and they must be adequately and effectively enforced. Even if we assume that regulations can succeed in decreasing or eliminating bank failures, the total costs of banking regulations can be much higher than the costs of bank failures. It is the costs and benefits of the various proposals that regulators, economists, and bankers need to take seriously in reforming the present banking system.

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Time to Repeal the Public Utility Holding Company Act

R. Richard Geddes

The Public Utility Holding Company Act of 1935 (PUHCA)[1] was passed during the Great Depression in response to the failure of a number of utility holding companies and subsequent investor losses. Many investors were defrauded due to information problems peculiar to the holding company structure. The utility holding company structure undoubtedly helped disguise unscrupulous practices, such as the bilking of subsidiaries through service contracts, inappropriate depreciation techniques, and the use of inflated property values, all of which contributed to the collapse of the holding companies (Hawes 1987).

Numerous holding-company activities are subject to regulation under PUHCA, including the acquisition and sale of securities, the acquisition of utility assets, intercompany transactions, service, sales and construction contracts, and reports and accounts. Importantly, PUHCA places restrictions on mergers involving registered holding companies.

An important aspect of policy analysis is the review of old regulations in light of economic change and technological progress. The character of the electric utility industry has changed, and will continue to change, in a way that makes the Act more costly:

- Financial analysis and accounting standards have evolved in such a way as to make its provisions unnecessary.
- PUHCA limits the choice of organizational structure for many firms, both utilities and non-utilities.

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[1]Pub. L. No. 74-333, 49 Stat. 803 (1935) (codified as amended at 15 U.S.C. §79a *et seq.*).

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- It restricts the market for corporate control and protects entrenched managers.
- It limits the ability of utilities to diversify, both across regions and across industries.

PUHCA imposes substantial costs on shareholders and customers of the electric utility industry with no offsetting benefits; it is time for its repeal.

The Features of PUHCA

PUHCA was designed to "integrate and simplify" the structure of utility holding companies. The Act defines a utility holding company as "any company which directly or indirectly owns, controls, or holds with the power to vote, 10 per centum or more of the outstanding voting securities of a public utility."[2] A utility that becomes a holding company is potentially subject to the full provisions of PUHCA and must register under the Act.

PUHCA established two broad categories of utility holding companies: registered holding companies and exempt holding companies. Firms can apply to become exempt holding companies under any of five statutory exemptions. Of the five, the two main exemptions are (1) if the utility's operations are predominately in a single state or (2) if the utility is predominately an operating utility. Those requirements encourage exempt utilities to operate in a single state and to maintain relatively simple organizational structures if they wish to retain their exemptions.

An important provision of PUHCA, known as the "two-bite rule," that does apply to exempt firms is Section 9(a)(2). This section prohibits any firm that owns 5 percent or more of the voting securities of any public utility from acquiring 5 percent or more of the voting securities of another public utility without prior SEC approval. An exempt holding company also is precluded from organizing under a non-utility parent company. Thus, if PUHCA were repealed, both exempt and registered holding companies would have more organizational flexibility than they do today.

PUHCA regulates a number of registered holding company activities, including financing through the issuance of securities, the acquisition of utility assets, various intercompany transactions, record-keeping and accounts, and contracts between operating and service companies. Registered holding companies must file numerous routine and transaction-specific reports with the Securities and Exchange

[2]Section 2(a)(7)(A) of PUHCA.

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Commission, some of which must be certified by independent public accountants.

Registered holding companies must obtain prior SEC approval for most types of securities issuances and for ensuring that acquisitions are not detrimental to the goal of integrating and simplifying holding companies. Regarding non-utility acquisitions, Section 11(b)(1) of PUHCA greatly restricts registered holding company activities. It states that a registered system can retain a non-utility system only if it is "reasonably incidental or economically necessary or appropriate to the operations of [an] integrated public-utility system." This provision has been interpreted to mean businesses that supply or serve the utility system, such as coal mines or rail lines (SEC 1982). Section 11(b)(1) also requires that each registered system be limited to a "single integrated public-utility system." This provision has been interpreted as placing a virtual ban on the acquisition of geographically distant utility assets through holding companies. Thus, registered holding companies are confined to one geographic area, which greatly limits merger activity among utilities (Harvard University 1995).

This overview suggests that PUHCA differs fundamentally from classic utility regulation. The Act attacks the use of the holding company structure in the electric and gas utility industries by restricting and micromanaging the *organizational form* that managers choose for their firm. While PUHCA restricts a part of the economic *process*, classic rate-of-return regulation is typically concerned with regulating *outcomes*, such as prices and service levels. Today, this constraint on a particular organizational form is outdated and unnecessary.

Recent Legislation and PUHCA's Obsolescence

The structure of the electric utility industry has changed significantly during the past two decades as a result of policy changes on both the state and federal levels. The Energy Policy Act of 1992[3] facilitated the development of wholesale power markets where power is bought and sold for resale over large grid networks, often covering several states. These markets are growing rapidly and continue to evolve. Under the Energy Policy Act, the Federal Energy Regulatory Commission required investor-owned utilities to provide access to their transmission grids to all wholesale customers and other utilities (SEC 1995: 19).[4] The provision of these transmission services, known as "wheeling"

[3]Pub. L. 102-486, 106 Stat. 2776 (1992).

[4]In March 1995, the FERC required utilities to provide users access to their transmission grids at the same price they would charge themselves.

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services, has increased the amount of power bought and sold in a market setting and increased competition. On the wholesale level, the Energy Policy Act ended utilities' 90-year-old monopoly status. Moreover, any person, including a registered holding company, can acquire an "exempt wholesale generator" without seeking prior approval from the SEC (ibid.: 20).

Although PUHCA no longer restricts entry into the wholesale electricity business, it continues to do so for retail business. The Energy Policy Act, however, left end-user deregulation to the states, so competition is increasing on the retail level as well, through state regulatory commission decisions. The California Public Utilities Commission recently approved a plan under which large retail customers can shop for power by 1998, and all other customers can do so by 2003 (Holden 1995). Under the plan, California soon will have a system of mandated retail wheeling in which all customers can contract with their supplier of choice. Other states, such as Rhode Island, Wisconsin, and Michigan are considering similar plans.

Mandates requiring common carriage of power over the grid, however, need to be recognized for what they are: a taking of private property for public use requiring compensation under the Fifth Amendment. Perhaps because of a fascination with classic theories of regulation, many commentators have tended to ignore the private nature of utility property. Conventional economic theories of regulating the grid as a natural monopoly leave little room for compensation of the regulated party.

Growing competition has led to new types of organizational forms, including cogenerators and small independent power producers. Called "non-utilities," these facilities enjoy substantial regulatory advantages over other utilities and constitute an important alternative source of energy. Non-utility generation increased rapidly in the 1980s; by 1992 it accounted for 10 percent of total U.S. generation (Baumol and Willig 1995: 4). Non-utility generators added more net capacity in the 1991–92 period than did utilities. Today additional units of generating capacity are as likely to be provided by non-utility generators as by utilities, and forecasts suggest that the importance of non-utility generation will increase in the future. The rise of these new generators means that the structure of the industry is changing so as to include new organizational forms. The traditional vertically integrated operating utility is no longer the sole provider of energy.

Many of the concerns addressed in PUHCA reflect the structure of the industry in 1935.[5] Indeed, the integration and simplification

[5]For example, the SEC (1982: 4) stated, "Continuation of the 1935 Act constitutes, in effect, a judgement that the industry today should conform to a structure deemed best in 1935. The Commission believes that the Congress should consider whether the Act now

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requirements have been described as "the very heart" of the statute (SEC 1982: 17). Electricity then was considered to be strictly a natural monopoly, which led regulators to grant legal monopolies. With such legal monopolies there was a substantial concentration of power, so limits on a firm's geographic boundaries and its outside investments made sense. The changes described earlier suggest that market power is being reduced both by the introduction of market forces and by new organizational forms. Competition is increasing rapidly in the utility industry and will continue to increase in the foreseeable future, thus making irrelevant the concerns that motivated PUHCA.

It is not necessary to wait for complete retail competition before repealing PUHCA. Rather, PUHCA repeal logically follows from deregulatory efforts that have already occurred. The Act essentially exposes the subset of firms subject to its full provisions to unfair, onerous regulatory requirements that are inconsistent with the rule of law and the level playing field required for a fully competitive market.

PUHCA and the Choice of Organizational Form

In a monopolistic, rate-of-return regulated environment, a substantial amount of inefficiency can be accommodated in the firm's organizational structure before the firm suffers financially. In a competitive environment, however, inefficiently structured firms are more likely to suffer. As the utility industry becomes more competitive, the market process will replace the regulatory process in the determination of managerial decisions.

Managers typically have the most information about their firm's environment and seek to maximize their firm's value subject to existing organizational rules. As market conditions become more critical to the success of public utilities, managers will have an incentive to use holding companies to diversify and lower transactions costs.

Diversification through Holding Companies

The holding company structure is a modification of the limited liability company that provides a way for firms to "compartmentalize" the risk associated with various business activities. For example, a subsidiary can go bankrupt, while the assets of the holding company are protected. A firm can lower the risk, and therefore the cost, of utilizing its financial, managerial, and engineering capabilities in other businesses, both utility and non-utility. With a minimum of internal

locks the public utility industry into a structure that is no longer responsive to changing market conditions in the nation's energy needs." If that was true more than 15 years ago, it is certainly the case today.

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organization costs, a firm can diversify across regions and across industries.

There are a number of benefits of utility diversification across geographic regions. First, by diversifying across regions, utilities are able to efficiently manage electricity demand and more fully utilize their expensive "peaking power" so units are not left idle. Second, geographic diversification allows the utility to efficiently manage its entire mix of generating capacity in a way that will minimize the total cost of meeting its requirements (Joskow and Schmalensee 1983). Such geographic diversification also allows the utility to diversify its fuel sources so the utility will not be dependent on a single coal mine or gas pipeline for fuel.

Third, diversification across jurisdictions allows "regulator diversification," as firms are able to minimize the risk of idiosyncratic decisions. If utilities are limited to one or two state regulatory jurisdictions, they must tolerate the sentiment and policies of those regulators. Regulatory risk is well recognized in the literature as one of the most important risks facing utilities. Regulators may prevent utilities from recovering the costs of large investments by denying rate increases or dictating accounting methods that adversely affect profits. There is wide diversity in policy across regulatory jurisdictions.[6] The restrictions on geographic diversification in PUHCA force utilities to bear risk inefficiently.

There are additional benefits of geographic diversification that are not risk-related. For example, mergers between utilities are important because the regulatory process required to approve new facilities is lengthy. A firm that needs new capacity often can acquire it more quickly (and less expensively) through acquisition. Utility mergers can also be viewed as a way to speed up the process by which firms adjust to new market conditions. While there are substantial benefits associated with geographic diversification, the costs appear to be minimal. Indeed, some utilities that utilize the divisional structure to diversify, such as UtiliCorp and PacifiCorp, currently operate disbursed systems with no visible harm to the public (Harvard University 1995).

There are many non-utility activities that utilities are likely to participate in intensively under PUHCA repeal, because they have a comparative advantage in these activities. An important example lies in cable TV and telecommunications. The electric utility industry currently has a strong comparative advantage in those markets, because it has

[6]This diversity has created a market for firms such as Duff and Phelps that specialize in rating the favorability of regulatory commissions to the utility.

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already laid more than 10,000 miles of fiber optic cable, with much existing slack capacity (Carpenter and Graves 1995). Utilities will expand this capacity, particularly with the advent of home energy services such as "real-time pricing" of electricity. Provision of these services requires the installation of cable into the home. Installation would allow utilities to compete directly with cable TV providers as a side benefit of providing energy services, thus reducing cable prices to the consumer. The benefit is critical because direct competition in cable TV services currently is limited.

Internal Transactions Costs

The holding company structure is also helpful in lowering transaction costs within a firm. The lower transactions costs stem mainly from the compartmentalization of activities that is possible under the holding company form. Such transparency allows management to avoid internal cross-subsidies, and the concomitant efficiency losses, between business activities. Second, the separation of entities allows managers to allocate resources among various parts of the business more carefully, an activity that assists in capital budgeting. Profit maximization dictates that new investments be made only when the expected rate-of-return for the activity exceeds its cost of capital. The separation of subsidiaries allowed by the holding company structure facilitates this type of calculation, because managers can more easily scrutinize various activities.

The holding company structure also assists with financing. A holding company may be able to obtain financing for a non-utility activity, or for a particular utility subsidiary, that it could not obtain otherwise, because the lender has assurance that other aspects of the business will not interfere with the financed activity. Potential lenders can more easily assess the costs and benefits of the particular activity. Additionally, financiers have more flexibility, because they can fund particular units of an enterprise without interfering with other divisions.

Further evidence of the value of the holding company form stems from the fact that utilities continue to organize under this structure despite the substantial regulatory costs imposed by PUHCA. Four mergers have been announced which, if approved, would increase the number of registered holding companies to 16.[7] Thus, the perceived

[7]Presently only 12 systems are regulated under PUHCA, of which nine are electric and three are gas systems. In 1935, PUHCA applied to over 200 registered holding companies. The announced mergers are Union Electric and CIPSCO, Inc.; Public Service Company of Colorado and Southwestern Public Service; Northern State Power and Wisconsin Energy Corporation; and a three-way merger of WPL Holdings, IEC Industries, and Interstate Power Corporation.

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benefits of the structure must outweigh the regulatory costs. As noted, PUHCA has been rendered obsolete by the development of accounting standards and financial analysis. I shall now discuss those changes in detail.

The Development of Securities Analysis

Several studies of utility holding companies, requested by Congress, were undertaken before the passage of PUHCA. Overall, the studies imply that inadequate disclosure and analysis were the main concerns in enacting PUHCA. Therefore, in considering repeal of the Act, one should focus on how information regarding holding companies' operations has evolved. In this section, I discuss how this has occurred through enhanced accounting standardization, improved accounting techniques, more sophisticated financial analysis, and the growth of expert financial intermediaries (SEC 1982: 30).

A major goal of PUHCA was to standardize accounts and increase financial disclosure. In 1935, this goal was a legitimate concern because the accounts of utilities were sometimes manipulated and often difficult to read, and accounting practices varied widely across firms. However, numerous developments in the accounting and investment professions have rendered these requirements unnecessary. Financial analysis is now much more sophisticated. There is a large degree of financial disclosure demanded of any firm, but particularly those listed on national exchanges with large amounts of stock, as is typical of utilities.

The accounting profession has matured substantially since the Depression. For example, the Financial Accounting Standards Board (FASB) has developed uniform accounting standards that must be used by all accountants who are members of the American Institute of Certified Public Accountants. All financial statements certified by a member of the AICPA must follow rules established by FASB. The strict accounting standards envisioned by the framers of PUHCA for the utility industry have thus been spontaneously assimilated into the accounting profession and are now widely enforced by it. Any utility wishing to enjoy the benefits of audited financial statements must meet the standards.

Any company wishing to obtain financing through organized securities markets must also meet FASB's norms for disclosure and uniformity. The growth of securities analysis as a profession and the adoption by that profession of strict standards ensures that a firm not willing to abide by them will be effectively prohibited from using the markets. Because of the benefits of adopting FASB's rules, particularly for asset-intensive firms, there is a strong incentive to meet the prevailing

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standards. Apart from securities analysis, the growth of expert intermediaries between firms and individual investors, such as mutual and pension funds, ensures that firms are subject to a high level of financial scrutiny. Moreover, expert rating agencies such as Duff and Phelps, Moody's, and Standard and Poor's, provide a heightened level of scrutiny.

PUHCA and the Market for Corporate Control

PUHCA has profound effects on the market for ownership of both utilities and non-utilities. The market for corporate control is the market in which the ownership, and thus control, of corporations changes hands. In this market various managerial teams compete for the right to manage corporate resources (Jensen and Ruback 1983). Incumbent managers are often replaced when ownership changes hands; they have an incentive to use corporate resources more efficiently knowing that they can be replaced. Both an actual takeover and the threat of a takeover are important in encouraging managers to maximize firm value (Manne 1965).

Firms with skilled managerial teams create value by acquiring poorly managed firms and increasing their market value. Statistical evidence substantiates the view that takeovers create social benefits and improve corporate performance (Jensen and Ruback 1983; Jarrell, Brickley, and Netter 1988). An active market for corporate control is particularly important in the electric utility industry. PUHCA imposes costs by limiting the market for corporate control; the market would be more efficient if PUHCA were repealed.

Utilities and the Market for Corporate Control

In most industries, the competitive forces of the marketplace help discipline corporate managers. If the firm is inefficiently managed, the price of the firm's product will not be competitive and the firm will lose market share. In industries that are rate-of-return regulated the firm is granted a geographic monopoly by law. The competitive forces of the marketplace are absent. Theoretically, regulators are to substitute for market forces in the enforcement of managerial discipline.

Regulators are unlikely to be effective substitutes for market forces, however, for several reasons. They will react only with a lag, at least as long as the regulatory proceeding, and typically intervene only when the utility requests a rate review. Market forces affect the firm much more rapidly. Moreover, regulators are loath to make politically unpopular decisions that harm consumers or shareholders. Instead,

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regulators are likely to respond to the force of organized pressure groups (Peltzman 1976).

It is therefore desirable to supplement the efforts of regulators with an active market for corporate control. Unfortunately, there are currently many regulatory bodies that simultaneously oversee utility mergers,[8] so takeover activity in the electric and gas utility industry has historically been quite limited. In the period from 1960 to 1986, for example, there were only nine hostile takeover attempts and none were successful (McLaughlin and Mehran 1995). In the five years from 1986 to 1990 (when there was a belief that deregulation would enhance the chance of success), there were 13 takeover attempts but only one was successful.

It could be argued that there is no incentive to acquire utilities, as the regulatory process would remove any gains (Ray and Thompson 1990; Ray et al. 1992). However, McLaughlin and Mehran (1995) show that the stock returns around the time of the announcement of a utility merger are positive, but are significantly smaller than if the target were not regulated. Thus, even though the takeover market for public utilities is greatly weakened by regulation, the gains from takeovers still persist.

Delay of takeovers, such as occurs through the lengthy regulatory approval process, is also harmful. First, incumbent managers of the target firm benefit from long delays between the announcement of an intended takeover and its consummation. This delay allows them to arrange takeover devices. Second, numerous pressure groups (such as environmentalists and consumer advocates) have an opportunity to coalesce and have an incentive to slow or subvert the regulatory process to gain concessions that would normally not be granted. The problem occurs even if the merger is socially beneficial. In an unregulated setting, those groups are less likely to affect the outcome of the merger.

For those reasons, an active market for corporate control is particularly important in the utility industry. Emphasis should therefore be placed on repealing PUHCA to facilitate the market.

PUHCA's Effects on the Market for Corporate Control

PUHCA creates a substantial barrier to utility takeovers. Indeed, that federal law has been cited by researchers as a critical barrier to utility takeovers. While there are other barriers (such as takeover defenses, state regulations, and competing offers) federal law remains, if not the most, certainly one of the most significant barriers. In a

[8]Regulatory bodies include the Securities and Exchange Commission (through PUHCA), the Federal Energy Regulatory Commission, and the Department of Justice.

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study examining the nine hostile utility takeover attempts that occurred between 1960 and 1986, Robyn McLaughlin and Hamid Mehran (1995: 184) found that six failed "primarily because of federal regulatory procedure based on the Public Utility Holding Company Act of 1935."

PUHCA affects the market for corporate control by discouraging non-utilities from bidding for utilities. As noted earlier, a firm that acquires more than 10 percent of the equity of a utility must register as a holding company, with all the regulatory constraints that implies. The Act then requires that the firm be "simplified" into a single, unified utility system. The requirement applies to utilities as well as non-utilities and is typically not an attractive option for a potential bidder.[9] Thus, PUHCA discourages non-utilities from entering the utility market. If the costs of utility ownership were reduced, more non-utilities would undoubtedly compete for the ownership of utility assets. Non-utilities would likely become significant players in the market for utility control and improve the efficiency of utility managers.[10]

PUHCA also discourages takeovers from other utilities. The Act discourages the acquisition of utility assets or securities by other utilities that are not physically interconnected or capable of such interconnection.[11] Under this regime, utility managers are essentially limited to takeover pressure from other firms in their state, a situation that constitutes a severe restriction on corporate ownership.[12] If U.S. utilities were able to acquire any other utility, contiguous or not, the opportunity would increase the pressure on utility managers from takeovers and consequently increase their efficiency.

An additional degree of corporate control benefits obtains from foreign utilities (and foreign non-utilities) buying U.S. utilities. Currently, the cost to foreign companies of buying U.S. utilities is increased by PUHCA because the firms must also meet its requirements. Foreign firms face SEC regulatory oversight and until recently no foreign

[9]The SEC has not been amenable to industrial firms acquiring utilities (see McLaughlin and Mehran 1995).

[10]Although it is difficult to predict precisely which firms would acquire utilities, it is likely that firms in similar "network" industries, such as telecommunications or cable TV, in which managers have experience that can be applied to utilities, would be candidates.

[11]Section 11(b)(1) of PUHCA.

[12]McLaughlin and Mehran (1995: 188) write: "Because of the provisions of the 1935 Act and its interpretation and implementation by the SEC, the principal threat of a hostile takeover is from utility firms in the same state. Same-state utilities do not trigger the 'two-bite,' multiple jurisdiction rule of Section 9 of the 1935 Act, and, post-acquisition, they will satisfy the requirements of a 'simplified' utility system. Thus, they avoid the major federal regulatory impediments to the acquisition."

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acquisitions were allowed.[13] While the SEC has the discretion to allow such acquisitions, the regulatory process imposes substantial costs and uncertainty on them. Repeal of PUHCA would remove the additional layer of regulatory oversight and lower the cost of foreign acquisitions in the corporate control market.

By allowing utilities currently affected by PUHCA to enter non-utility businesses more freely, repeal of PUHCA would have benefits in enhancing corporate efficiency in other non-utility industries. Given the substantial cash flows and limited growth prospects in some utility markets, utility managers have the resources to effectively compete for control in many industries.

In sum, there are a number of reasons to believe that reform of PUHCA would result in increased efficiency through a more fluid market for corporate control. Both direct administrative costs and the chilling effect caused by uncertainty over regulatory approval would be eliminated. Heightened pressure on managers due to intensive takeover threats has been shown to improve the operation of firms. Managers of utilities are currently insulated from market pressures by the regulatory process; many control mechanisms that motivate unregulated managers are absent here. It is thus important to ensure that the market for corporate control operates as smoothly as possible in this industry.

Conclusion

Given the large number of potential competitors and the homogeneity of electricity, the provision of power has the potential to become one of the most competitive industries in the United States. Such competition would have vast social benefits, but major steps must be taken to achieve it, chief among which is the repeal of obsolete and counterproductive regulations.

PUHCA unfairly penalizes certain utilities because of their organizational structure. Repeal is necessary to create a level playing field and a genuine free market in electricity. It is not necessary to wait for complete retail competition in the industry to enjoy the benefits of PUHCA repeal. Benefits such as a more active corporate control market, more entrepreneurial managers, and firms that can efficiently manage risk would be forthcoming immediately.

[13]In 1994, the SEC for the first time allowed the acquisition of a U.S. utility (a gas utility in Vermont) by a foreign utility, a Canadian pipeline (*Gaz Metropolitain, Inc.*, Holding Co. Act Release No. 26170, 23 November 1994). This case suggests that there is interest by foreign firms in acquiring U.S. utility assets.

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The laws governing corporate form should be adjusted to the technology, information, and market structure of the time. Substantial changes in utility markets, in the methods and costs of corporate control, in financial markets, in transmission technology, and in regulatory techniques since 1935 have made PUHCA a costly anachronism.

The Public Utility Holding Company Act imposes substantial direct and indirect costs on society, with no concomitant benefits. It is no longer in the public interest. Diligent public policy assessment requires review of old regulations as well as consideration of new ones. It is clear that PUHCA is a law that is no longer appropriate for the utility industry. Indeed, the SEC stated that its goals were achieved more than 20 years ago (SEC 1982). Of all the laws regulating utilities today, PUHCA may well be the most antiquated. Its detailed provisions continue to inhibit the market discovery process and to ward off hobgoblins that have long ceased to exist.

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Trade and Human Rights: The Case of China

James A. Dorn

> Vigorous economic development leads to independent thinking. People hope to be able to fully satisfy their free will and see their rights fully protected. And then demand ensues for political reform. . . .The model of our quiet revolution will eventually take hold on the Chinese mainland.
>
> —Lee Teng-hui

The Path toward Freedom

The rise of democracy in South Korea and Taiwan attests to the power of the market in generating political liberalization. Both countries have moved from closed, authoritarian regimes to open-market democracies without bloody revolutions and without the threat of economic sanctions. The question is, will China follow?

China has created a vibrant economic space by discarding central planning and allowing experimentation with new ownership forms. Since 1979 China's economy has grown at an average annual rate of more than 9 percent and has the potential to become the world's largest economy during the 21st century. Although the Chinese Communist Party (CCP) has held onto its monopoly of political power, China is a more open society today than it was a decade or two ago. There are still serious violations of human rights, but a case can be made that China is creeping along in the right direction and, in time, may follow Taiwan's "quiet revolution."

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The critics of China's human rights record are justified in pointing out the abuses that are occurring in China. Yet, many of those critics (e.g., Rep. Nancy Pelosi [D-CA]) underestimate the importance of trade liberalization as a strategy for bringing about systemic change in China. They also fail to distinguish between those human rights that can be universalized and are consistent with individual freedom and those alleged rights that cannot be extended to everyone without violating fundamental rights to life, liberty, and property.

Article 25 of the U.N. Declaration of Human Rights states that each person "has the right to a standard of living adequate for the health and well-being of himself and of his family, including food, clothing, housing and medical care and necessary social services" (Ravitch and Thernstrom 1992: 204–5). If sanctions were imposed on China for failing to protect those alleged economic and social "human rights"—rights that cannot be found in the U.S. Bill of Rights, that cannot be universalized,[1] and that cannot be implemented in a world of scarcity—China would become less free and less prosperous. Before acting too hastily, human rights advocates need to think more clearly about the nature of human rights and how best to help China along the path toward a free society.[2]

The threat of using trade restrictions to advance human rights is fraught with danger. Free trade is itself a human right and rests on an individual's rights to life, liberty, and property—rights the U.S. Founding Fathers regarded as inalienable and self-evident. When the federal government closes U.S. markets to countries with governments that deny their citizens certain civil liberties, it robs those citizens of one more freedom and undermines the market dynamic that in the end is the best instrument for creating wealth and preserving freedom.

China serves as a case in point. Denying China most-favored-nation status or imposing sanctions would politicize trade, strengthen the CCP, and harm many innocent people. Sanctions also would violate Americans' rights to liberty and property by interfering with free trade.

Free Trade as a Human Right

The proper function of government is to cultivate a framework for freedom by protecting liberty and property, including freedom of contract (which includes free international trade), not to use the power of government to undermine one freedom in an attempt to

[1]Unlike freedom of speech and the right to own property, the right to welfare entails positive obligations and violates the liberty and property of others.

[2]On the nature of human rights and their relation to freedom, see Pilon (1979, 1986).

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secure others. The right to trade is an inherent part of our property rights and a civil right that should be protected as a fundamental human right.

The supposed dichotomy between the right to trade and human rights is a false one. Market exchange rests on private property, which is a natural right. As moral agents, individuals necessarily claim the right to liberty and property in order to live fully and to pursue their interests in a responsible manner.[3] Without private property and freedom of contract, other rights—such as free speech and religious freedom—would have little meaning, because individuals would be at the mercy of the state. The human-rights fabric is not made stronger by unraveling economic liberties in the hope of enhancing other liberties.

Protectionism violates human rights. It is an act of plunder that deprives individuals of their autonomy—an autonomy that precedes any government and is the primary function of just governments to protect (see Bastiat [1849] 1964). The danger of buying into the argument that restricting trade with China will increase human rights is that such an argument diminishes the significance of the moral case for free trade, politicizes economic life, and weakens the market-liberal vision—a vision that needs to be strengthened in order to protect civil society and human liberty.

Commerce and Good Government

Those who argue that sanctions will damage a target country's economy enough to bring about political liberalization argue more from emotion than from reason. There is no logical connection between sanctions and liberty. Economic sanctions are really a "feel good" approach to promoting human rights without any chance of being effective.[4] Indeed, sanctions antagonize the governments of target countries and radicalize those in power.

In contrast to the "feel good" approach of sanctions, the logic of trade liberalization posits a close link between increasing economic freedom and securing human rights. Unlike sanctions, trade liberalization weakens the power of government and civilizes nations. The institutional infrastructure of a market system is supportive of personal

[3]For a survey of the literature bearing on the sources of human rights, see Palmer (1996: sec. III).

[4]Bruce Bartlett (1985: 10), in his study of sanctions, concluded that economic sanctions "are a way of making ourselves feel that we are doing something substantive about a serious problem without really doing anything at all. The problem is that we are paying a heavy price for invoking this 'feel good' policy over and over again."

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freedom and good government. Free markets, based on private property and consent, encourage individual responsibility, self-esteem, social mobility, and tolerance—all of which are associated with human rights and democracy.

Even though free markets are neither necessary nor sufficient for democracy, there is much evidence to support the argument that economic liberalization breeds political liberalization. As markets spread, people acquire greater wealth and have a stronger interest in participating in the political process and protecting their property. Freer markets thus give rise to political regimes that are more tolerant of human rights and are more likely to safeguard them. Michael Novak (1996: 2) writes,

> The capitalist preference for law and due process leads naturally enough to the . . . basic institutions of democracy: the rule of law, limited government, separated powers, and the protection of the rights of individuals and minorities.

The rule of law is a by-product of commercial society. Traders who were discriminated against by rulers found ways to circumvent the sovereign and increase their wealth. Montesquieu, in *The Spirit of the Laws* (*De l'esprit des lois* [1748]), explains how Jewish merchants invented the bill of exchange to prevent having their property subject to the whim of rulers (book XXI, 20), and how foreign exchange markets provided constraints on the ability of rulers to debase the currency (book XXII, 13). Today international capital markets put pressure on government policymakers to protect private property rights and to pursue prudent monetary, fiscal, and regulatory policies or face massive capital outflows. Global market competition helps good government crowd out bad government.

Montesquieu's observation that market innovations compel rulers "to govern with greater wisdom than they themselves might have intended" is based on his insight that "only good government brings prosperity" (book XXI, 20).[5] The collapse of communism—first in Eastern Europe and then in the Soviet Union—is testimony to the power of Montesquieu's vision.

In *The Wealth of Nations*, Adam Smith ([1776] 1937: 385) describes how the development of commercial life in Europe "gradually introduced order and good government, and with them, the liberty and security of individuals." Likewise, French liberals Benjamin Constant and Alexis de Tocqueville emphasize how commerce creates a love

[5]Quoted in Hirschman (1977: 72). For a discussion of Montesquieu's views on the relation between markets and government, see Hirschman (ibid.: 70–80).

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of liberty. According to Constant ([1819] 1988: 315), "Commerce inspires in men a vivid love of individual independence. Commerce supplies their needs, satisfies their desires, without the intervention of the authorities." And according to Tocqueville ([1835] 1969: 637), "Trade makes men independent of one another and gives them a high idea of their personal importance; it leads them to want to manage their own affairs and teaches them how to succeed therein."

Harvard economist Robert Barro's recent empirical work, summarized in *Getting It Right*, shows that earlier writers were correct in seeing a close connection between free trade and free people. Barro (1996, 11) finds "that improvements in the standard of living . . . substantially raise the probability that political institutions will become more democratic over time." He concludes,

> The advanced Western countries would contribute more to the welfare of poor nations by exporting their economic systems, notably property rights and free markets, rather than their political systems, which typically developed after reasonable standards of living had been attained. If economic freedom can be established in a poor country, then growth would be encouraged, and the country would tend eventually to become more democratic on its own.[6]

Trade Liberalization and Democratization in China

China has passed the test of economic growth, but the world's fastest growing economy has yet to achieve a true market system with widespread private ownership and a political system that respects human rights. Even so, a strong case can be made that the gradual introduction of markets in China and the opening of China to the outside world have made the Chinese people freer and reduced the power of government.

The end of collectivized agriculture in 1978 and the return of farming to families under the household responsibility system (*baochan daohu*) changed the whole dynamic of economic, social, and political life in China. The state was no longer the master for 80 percent of China's population who lived in rural areas. Farmers became risk takers, created new markets, developed rural industries, and migrated to urban areas. Farmers were no longer slaves to the state: they sought alternatives to government employment and were driven to survive without state welfare support. They resisted state coercion and initiated what Kate Xiao Zhou (1996: 4) calls "a spontaneous, unorganized,

[6]For studies of the degree and scope of economic freedom, see Gwartney et al. (1996), Johnson and Sheehy (1996), and Messick (1996).

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leaderless, nonideological, apolitical movement (SULNAM)" that transformed the old communist system and enhanced human rights.[7]

The quiet revolution that has been taking place in China's economy since 1978 is combining with the information revolution to strengthen the fabric of civil society, especially in China's southern coastal provinces. Commenting on China's cultural transformation, Jianying Zha (1995: 202) writes in her book *China Pop*,

> The economic reforms have created new opportunities, new dreams, and to some extent, a new atmosphere and new mindsets. The old control system has weakened in many areas, especially in the spheres of economy and lifestyle. There is a growing sense of increased space for personal freedom.

Anyone who has visited China and seen the vibrancy of the market, the dynamism of the people, and the rapid growth of urban areas will concur with Zha's cautious optimism.

Commercial life in China is evolving naturally as people flee the countryside for improved living conditions and the chance to strike it rich in the growing nonstate sector.[8] Villages that were once small fishing centers along the southern coast are now booming with the flow of trade and people. The new urban centers, such as Shishi in the province of Fujian, are characterized by the market, not the plan. Their model of development, writes Kathy Chen (1996) of the *Wall Street Journal*, is "*xiao zhenfu, da shehui*—small government, big society—which advocates less involvement by cash-strapped governments and more by society."

Ambitious young people want to become capitalists, not communists.[9] A recent survey found that young people ranked being an entrepreneur first among 16 job choices and employment with the national government eighth (Kristof 1993). Freer labor markets have

[7]Zhou's book *How the Farmers Changed China* is a brilliant portrayal of how this process occurred. According to Zhou (1996: 10), "*baochan daohu*, markets, rural industry, and migration all reduced official control over peoples' lives, particularly rural people's lives. This great increase in autonomy surpassed anything experienced before in the People's Republic."

[8]The nonstate sector consists of all enterprises not directly controlled by the central government or by provincial governments. Nonstate enterprises include urban and rural collectives (of which township and village enterprises are particularly important), individually owned enterprises, foreign-owned enterprises, and joint ventures. Unlike state-owned enterprises, collectives face a hard budget constraint and are primarily market driven. If the current growth of the nonstate sector continues, by the year 2000 nonstate enterprises will account for more than two-thirds of China's industrial output and as much as 40 percent of China's GDP (Bell, Khor, and Kochhar 1993: 13).

[9]Joseph Kahn and Marcus Brauchli (1994) report, "Top university graduates used to consider party membership a career-gilding rite of passage, required for advancement through the ranks. Now, they scorn party recruiters."

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led to a growing demand among college students for business courses, and universities are responding.[10] The CCP has lost much of its credibility and is no longer the major route to success.

The freedom to trade is an important human right in China. As trade expands, there is a growing middle class with a large stake in China's future. Moreover, China's high savings rate gives all those who sacrifice current consumption and invest their earnings in the nonstate sector a strong incentive to further depoliticize economic life. The formation of economic and civil society will lead to a natural call for greater participation in political life. Yet as long as the CCP stands in the way of private property, thwarts the spontaneous market order, controls the flow of information, and prevents free association, the future of China's civil society will be in jeopardy.

If democratization is to proceed in China, the government needs to allow further experimentation with new forms of ownership. Writing in the Beijing press, Yuan Mu (1995: 64) emphasized the key role of ownership reform: "We should discover the best model for ownership by the whole people [notice the bias against privatization], so that they will genuinely become the main body of market competition and operate with vigor and vitality in accordance with the rules of the market economy."

Those rules will evolve as individuals grope for ways to lower the costs of exchange and expand markets. In *China Pop*, Zha (1995: 204) quotes Liu Ge, a lawyer trained in both China and the United States, as saying,

> Gradually, there will be more laws and rules; the market will be more mature, more compatible with international standards, the competition more fair and open. Then, China will have been structurally transformed! Political change will come after that.

According to Zha, "A lot of the educated urban Chinese . . . echo this way of thinking." There is reason to believe, therefore, that institutional change in China will bring about what Princeton University professor Pei Minxin (1995) has called "creeping democratization."

Pei (1994) believes that the gradual development of China's legal system toward affording greater protection for persons and property, the growing independence and educational levels of members of the National People's Congress, and the recent experiments with self-government at the grassroots level will help transform China into a more open and democratic society. He points to the upward mobility

[10]Market-oriented business courses are replacing Marxist courses at the People's University of China in Beijing. Lack of interest has led to the canning of 17 courses heavy on communist ideology but of little use to career-minded students (Walker 1993).

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of ordinary people, occasioned by the deepening of market reform, and to the positive impact of China's "open-door" policy on political norms. In his view, public opinion and knowledge of Western liberal traditions, such as the rule of law, "have set implicit limits on the state's use of power" and have promoted the democratization of the legal system. People are starting to use the court system to contest government actions that affect their lives, liberty, and property. There has been a sharp rise in the number of civil lawsuits against the state, and individuals are winning nearly 20 percent of the cases, according to official sources (Pei 1994: 12).

The opening of the legal system is important because it paves the way for the transition from "rule by law" to "rule of law." Marcus Brauchli (1995) of the *Wall Street Journal* writes,

> The state's steel-clad monopoly on the legal process, which makes the courts just another arm of government, is corroding. China's economic liberalization . . . has spawned a parallel legal reform that raises the prospect of rule of, not merely by, law.

Unfortunately, as Brauchli recognizes, "legal ambiguity" remains "a ruthless weapon" for harassing the population. Until that facet of China's institutional structure changes, no one's rights will be secure.

The challenge for China is to get out of the way of the market and let it grow naturally along with civil society. Doing so, however, requires an understanding of the institutional infrastructure that makes the market system tick and an appreciation of the spontaneous order that emerges when private property and freedom of contract are protected by law.

Democracy is multi-dimensional; the right to vote is only one dimension, albeit an important one (Dorn 1993). A free society requires constitutional constraints to limit the power of government so that the right to vote does not infringe on the right to property (Hayek 1960, Pilon 1992/93). China's future prosperity will depend increasingly on the development of a legal system that safeguards persons and property against the arbitrary force of the state and on the nation's commitment to comply with international commercial codes and customs.

The major impediment to China's freedom and long-run prosperity, of course, is the CCP. The crucial question is how to weaken the power of the CCP. Those who criticize the use of sanctions think that the surest route to China's freedom and prosperity is to keep trade open and develop China's civil society step by step. Greater economic freedom, they argue, will spill over into greater political freedom, as it has in other parts of Asia. Imposing economic sanctions, on the other hand, will destroy China's nascent market system and block the surest path toward freedom and democracy.

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China has been willing to experiment, but it has not yet provided the climate of freedom necessary for growing market-liberal institutions. There is now an effort, in fact, to give the central government greater power by ending the system of fiscal federalism.[11] Putting more money into the pockets of Beijing bureaucrats by recentralizing the tax system, however, is not the answer to China's problems. Nor will improving the management of state-owned enterprises do anything to solve the problems of loss-ridden firms that have no real owners.

Real stability will come to China only when its leaders abandon their fatal conceit and realize that it is impossible to plan the market or society (Dorn 1996). Although the leadership is willing to tolerate gradual reform to keep the economy strong, there is no indication that they will tolerate political reform. The crackdown on dissidents, especially the arrest of Harry Wu and Wei Jingsheng; the vow to prevent Hong Kong from following Taiwan's path; and the blatant hostility toward Taiwan before the presidential elections are clear signals that China's aging rulers continue to find any movement toward democratic rule unacceptable. The West should not confuse economic liberalization with a desire for democratization.

Economic Sanctions: A Blunt Instrument

Economic sanctions may be legitimate in certain cases—for example, banning goods made with slave labor or prohibiting the importation of pirated goods—but in most cases sanctions are a blunt instrument that may end up doing more harm than good. Sanctions often interfere with legitimate (voluntary) exchange and fail to achieve their desired policy objectives. Markets normally find ways to circumvent sanctions as traders substitute nonsanctioned goods for sanctioned goods or move goods through black markets by bribing enforcement agents. Moreover, even if sanctions are effective in imposing a large economic cost on the target country, they may fail to change the political climate.[12] Rulers who have a monopoly of power and control the media—such as in China, Cuba, Iran, Iraq, and North Korea—will use that power to generate anti-Western sentiment and to reinforce their ideology. Indeed, sanctions may strengthen the government

[11]On the nature of Chinese-style federalism, see Qian and Weingast (1995).

[12]According to William Kaempfer and Anton Lowenberg (1989, 713), "political studies have demonstrated that the political consequences [of sanctions] are quite often the opposite to those intended." The experience of Cuba, Iran, Iraq, Libya, and North Korea has demonstrated the futility of using sanctions against entrenched political elites holding rigid anti-capitalist views.

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of the target country by giving hard-liners a foreign villain for domestic problems.

Two questions need to be addressed when considering the use of economic sanctions: First, are sanctions legitimate? Second, are they effective—that is, will sanctions promote a market economy and will the economic effects of sanctions promote freedom and democracy?

The Question of Legitimacy

Although the general rule is for governments not to interfere with free trade, there are several cases in which governments would be justified in using economic sanctions. In the following five "exceptions," however, sanctions should be narrowly focused, not blanket bans on unrelated trade.

1. Sanctions would be legitimate in preventing trade with an enemy when such trade would directly enhance the enemy's military capability. The U.S. government, for example, would be justified in preventing the sale of military technology and weaponry that could be used by an enemy to harm U.S. citizens.
2. Sanctions would be legitimate in preventing the use of slave labor. Goods made with slave labor should not be allowed into the United States. However, it would not be legitimate for the United States to ban all trade with a country if only a small part of its exports were made with slave labor. Private traders should have the right to trade as long as they adhere to the principles outlined in the preceding discussion. To ban all trade or to use sanctions to ban many products not directly connected with slave labor would harm many innocent people.
3. Sanctions would be legitimate in preventing the use of prison labor in the case of innocent parties wrongly imprisoned (i.e., political prisoners who have not violated anyone's rights to life, liberty, or property). This case is analogous to the case of slave labor, except the slaves are behind bars.
4. Sanctions would be legitimate in protecting the rights of minors. The use of child labor is complicated, because in a poor country it may make sense for children to go to work at a much earlier age than in a rich country. There is no "bright line" to give an easy, clear-cut answer to when economic sanctions should be used to attempt to cut off trade in goods made by child labor. Only a short time ago in the United States, it was not uncommon for 12-year-olds to work long hours on a farm or in a factory to help their families survive. Should the United States now prevent

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those children from working in poor countries to improve living standards? Economic sanctions would do just that.[13]

5. Sanctions would be legitimate in safeguarding intellectual property rights. The U.S. government has a legitimate right to ban the importation of pirated computer software or compact discs, and is justified in penalizing foreign producers for violating U.S. copyright laws. Intellectual property rights are no less important than other forms of private property. Allowing thieves to sell CDs at very low prices would only encourage consumers to buy from the illegal suppliers and increase the incentive to steal. The tactic of using sanctions to enforce compliance with U.S. copyright laws should be supplemented with multilateral agreements to protect intellectual property rights. Admitting China into the World Trade Organization should be a top priority for the United States and other developed countries.

The United States, however, has no right to interfere with free trade for the purpose of promoting democracy or because a foreign government violates human rights. An individual's freedom to trade is a natural right, not derived from the power of government. That right should not be curtailed by a sanctioning country simply because the target government is nondemocratic or because it violates civil liberties. Violations of human rights should be condemned, but they do not warrant the denial of most-favored-nation status or the use of sanctions to curb legitimately traded goods.

The Question of Effectiveness

Whether sanctions are legitimate or illegitimate, they may not be effective. Sanctions are likely to be effective only when all the following conditions are met: (1) they have the near-unanimous support of the target country's major trading partners; (2) the government of the target country is responsive to the concerns of its citizens; and (3) the benefits of the sanctions to the governments of the sanctioning countries exceed the costs. Few sanctions meet all three conditions.[14] In particular, Gary Hufbauer, Jeffrey Schott, and Kimberly Elliott (1990: 92) found that economic sanctions "are of limited utility in

[13]During the May 1995 hearings on fast track issues, Rep. Philip Crane [R-IL] reminded his colleagues who wanted to impose U.S. labor standards on less developed countries that "historically, a child became a man at 12. Adolescence is a phenomenon of the 20th century, and it came about because we were affluent" (U.S. Congress 1995: 152).

[14]For a discussion of the difficulty of effectively implementing economic sanctions, see Hufbauer, Schott, and Elliott (1990: chap. 5) and Bartlett (1985).

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achieving foreign policy goals that depend on compelling the target country to take actions it stoutly resists."

The difficulty is to identify when trade is illegitimate and to target the relevant goods so that legitimate traders are not harmed. Sanctions may be justified in certain cases, but they are usually a poor means of promoting human rights and democracy. Instead of liberalizing a repressive regime, sanctions may in fact make the regime more repressive by banning exchanges that would extend markets and weaken the power of government. Trade restrictions also interfere with the economic liberty of Americans and harm U.S. consumers. Import restrictions presently cost the United States about $70 billion a year (Junkins 1995: 69). Such restrictions increase prices of both foreign and domestic goods and lead to inefficient use of resources, which reduces overall wealth. Economic sanctions are a blunt instrument and should not be considered unless legitimate rights are violated, the sanctions are targeted directly on the rights' violators, and there is a high probability of success.

Four potential problems make it difficult to successfully use sanctions to further human rights:

1. Target countries may circumvent sanctions by substituting new sources of supply for sanctioned products. Historically, sanctions have not been very effective because the targeted countries have been able to find suitable substitutes.
2. The costs of monitoring the target country for violating human rights, or for violating intellectual property rights, rise with the size and complexity of transactions and with the extent of the market. Sanctions, therefore, may be very difficult to enforce in large countries such as China.
3. Economic sanctions may lead to political backlash in the targeted country and fail to have a positive impact. That problem may be especially acute in regimes with an entrenched political class, no freedom of the press, and a strong anti-West bias.
4. Sanctions are apt to politicize trade in the sanctioning country, because politicians seek to win votes by using the rhetoric of protectionism to retain jobs or investments in their districts. Politicians have a legitimate interest in using economic sanctions to discipline foreign governments for their violation of human rights. The danger is that once the question of sanctions arises, there will be strong pressure from special interest groups to erect trade barriers to protect their industries from foreign competition. Protectionist rhetoric also will include reference to the bogeyman of bilateral trade deficits. Using protectionist mea-

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> sures to try to achieve a balance of trade with a single country, however, is both foolish and a violation of human rights.

That economic sanctions hinge on self-interest should be no surprise.[15] Those who favor linking U.S. trade policy to human rights are well-intended and have legitimate concerns, but those intentions and concerns are better addressed by trying to change the economic and political system of the foreign power not by imposing economic sanctions that have little chance of success. Restricting American businesses from investing and trading in China or other nondemocratic countries would weaken the nonstate sector and slow economic progress. As Stuart Anderson (1996) writes,

> U.S. corporations act as a liberalizing force, helping to strengthen the private sector, establishing alternative centers of power, and creating subtle but important pressures for democratic reforms. They also tend to raise wages and labor standards in the countries in which they operate.

The fall of the Soviet Union was not the result of sanctions, it was the result of the internal contradictions and weaknesses of the system of central planning and communism. The information revolution, the opening of markets, a strong U.S. national defense, and pressure from the West to conform to the rule of law were instrumental in ending the Soviet regime. The Jackson-Vanik amendment, which was intended to liberalize Soviet emigration policy, was not an important factor.[16]

Too often those who strongly support human rights fall into the trap of moving from legitimate to illegitimate arguments for imposing economic sanctions. During the July 1994 congressional debate over using trade policy to promote human rights, for example, Rep. Gerald Solomon (R-NY) took the position that Americans "must apply leverage where we can in order to defend freedom, deter aggression,

[15]For a discussion of the "self-interest hypothesis," as applied to sanctions, see Kaempfer and Lowenberg (1989). They found in the case of South Africa that economic sanctions (imposed in 1986) were based more on the self-interest of the sanctioning countries than on the public interest of the targeted country. Sanctioning countries choose to restrict specific imports (especially those that directly competed with products in the sanctioning countries) rather than inflict maximum damage on South Africa by a complete embargo. Most countries, therefore, continued to export to (and import from) South Africa.

[16]The Jackson-Vanik amendment was part of the Trade Act of 1974. Under the amendment, communist countries could be denied most-favored-nation status if they did not allow relatively open emigration. The amendment necessitates annual renewal of China's MFN status. See Duffy and Harrold (1996: 3). Stuart Anderson (1996) points to the ineffectiveness of Jackson-Vanik in increasing Jewish emigration from the Soviet Union. Between 1973 and 1975, Jewish emigration from the USSR fell by 62 percent, and in the early 1980s fell below 1,000 a year.

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and, yes, protect American jobs" (U.S. Congress 1994: H5948). If by "leverage," he means voluntarily using the buying power of U.S. consumers to discipline countries that violate human rights, then such leverage would be consistent with Americans' freedom of choice.[17] Far more likely, he means using the power of government to impose sanctions on countries that, in the end, may threaten American jobs.[18]

When the case for using trade policy to further human rights moves beyond the legitimate protection of human rights to the protection of American jobs, the state gains and the market loses—government becomes stronger in both the target country and the sanctioning country. The resulting decline in economic liberty will harm rather than help the cause of freedom and good government.[19] As Rep. David Dreier (R-CA) stated during the July 1994 congressional debate, "Denying trade is a violation of human rights and a reprehensible one" (U.S. Congress 1994: H5937).

The Case of China

China's lack of respect for human rights, its use of political prisoners, and its failure to protect property rights (including those to intellectual property) stem primarily from the CCP's monopoly of power—a monopoly that rests on the idea that rights do not belong to the people but are privileges conferred by the state and can be taken away at any time. Yet, the fact that China is a bad government does not justify the use of sanctions to prevent legitimate trade. In the event that China uses slave or prison labor, or violates U.S. copyright laws, the U.S. would be justified in penalizing the rights' violators, as previously

[17]U.S. firms and consumers have the market power to penalize firms and governments that violate human rights without any involvement of the U.S. government. David Birnbaum (1996) notes, "[In America] the government is not the only force capable of shaping trade policy. Increasingly, key decisions are being made by the companies that import products—and by the consumers on whom all trade ultimately depends. And when consumers decide to do something for human rights, there's nothing a presidential veto can do to stop them."

[18]During the May 1995 congressional hearings on "fast track issues," Rep. Bill Thomas (R-CA) recognized the danger of turning a legitimate concern for human rights into an agenda for protectionist policies that violate individual rights. Addressing his colleagues, he stated, "What concerns me is that, more recently, what I have seen as arguments on workers' rights tend not to be so much for underscoring the international agreements that I think all of us would agree with in terms of fundamentals—the slave labor, prison labor, and the rest—but appear to me to be more and more actually the reverse of what their proponents would hope people would think they were. Frankly, I think a number of them have been protectionist" (U.S. Congress 1995: 155).

[19]Corruption is the natural by-product of protectionism, because once the government holds the power to dictate the terms of trade and is able to control entry, traders will have to do business with government agents before they can do business with each other. Thus, economic life becomes politicized and bribes take the place of direct market prices.

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discussed. Before doing so, however, U.S. policymakers ought to consider the probability of success and consider alternative measures that may be more effective in the long run to change the nature of China's economic and political system.

In the case of China, economic sanctions have little chance of success. Although the United States accounts for more than 30 percent of China's export market, the threat of placing prohibitively high tariffs on a range of Chinese products is not politically feasible. American consumers would immediately see the higher prices and protest.[20] Even if such a policy were politically feasible, it would be difficult to implement because China could transship products through Hong Kong or other countries, and U.S. customs officials would find it hard to identify the point of origin. Likewise, restricting American exports to China, which amounted to $11.7 billion in 1995, or curtailing the billions of dollars U.S. investors have poured into China would cause a political backlash from stakeholders and would be difficult to enforce.

But even if the U.S. government could block flows of goods and capital to China, there is no guarantee that other countries would not step in to fill the gap. Instead of buying from Boeing or looking to American investors, the Chinese would shift to Airbus Industrie and look to European and Asian trading partners for additional capital—and U.S. investors would try to reroute their funds into China rather than abandon their invested capital.

Finally, if America were to ban trade with China, China would retaliate. The ensuing trade war would harm both countries, as well as the Asian tigers, and do irreparable damage to the evolution of the market and civil society in China.

Monitoring the use of prison labor and tracing goods made by political prisoners in China would be difficult but not impossible.[21] But even if the West were able to effectively monitor such activities, there is no guarantee that other countries would do the same. In fact, many countries have supported China against the United States when it comes to human rights. At the 52nd session of the U.N. Commission

[20]It is estimated that revoking China's most-favored-nation status would cost U.S. consumers from $16 billion to $29 billion in higher prices and lead to the loss of up to 200,000 American jobs (Donghui 1996: 3; Duffy and Harrold 1996: 4–5).

[21]Harry Wu (1996) notes that there are "more than 1,100 labor reform camps called the *laogai*" in China. As he puts it, "The laogai is not simply a prison system. It is a political tool for maintaining the Communist Party's totalitarian rule. Many of the laogai's 6 million to 8 million inmates are political prisoners." According to Wu, "forced labor from the laogai produces about one-third of China's tea and a significant amount of its cotton. About 60 percent of China's rubber vulcanizing chemicals are produced in a single laogai camp in Shanyang."

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on Human Rights (April 1996), an attempt to pass a U.S. sponsored resolution critical of China's record on human rights—especially with regard to Tibet, the criminal justice system, and religious freedom—did not even get off the ground. China proposed a "no action" motion, meaning no discussion of the resolution and no vote on it. The motion passed by a vote of 27 to 20, with 6 countries (including Mexico, the Philippines, South Korea, and Russia—all major recipients of U.S. aid) abstaining (Weibin and Wei 1996: 3).

The piracy of intellectual property is a significant problem for Western firms. China has been a major offender of copyright laws and needs to comply with the rule of law. China's membership in the World Trade Organization should be conditioned on China's adherence to international law. If China cannot play by the rules, it should not be allowed to play with those who do.

The problem is that most less developed countries, and even some developed countries, violate intellectual property rights. More than 84 percent of Chile's software, for example, is pirated (Holleyman 1995: 114). Using economic sanctions to punish pirates sounds good in theory, but in practice sanctions are seldom effective. The real solution to piracy may have to wait for technological changes that make it very costly to steal intellectual property and for the rule of law to evolve in China and other less developed countries. Meanwhile, the United States should continue to criticize China and other countries for their violations of copyright laws and use the threat of sanctions to help protect intellectual property. If China signs agreements to police piracy and protect intellectual property rights, as it did with the United States in February 1995, then China should be held accountable.

As China develops its own intellectual property, there will be a demand for new laws to protect private entrepreneurs in China. The uncertainty created by China's failure to protect intellectual property rights can only harm China in the long run. Investors will not enter a market if they cannot reap the full benefits of their investment. Fan Gang, an economist at the Chinese Academy of Social Sciences, predicts that things will change in China as people discover that clearly defined and enforced property rights are to their advantage:

> [People] are bound to find that all this cheating and protecting yourself from being cheated consume too much time and energy, and that the best way to do business is playing by a set of mutually respected rules. New rules and laws will be passed, and people will be ready to abide by them.[22]

[22]Quoted in Zha (1995: 203).

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The foremost reason economic sanctions are unlikely to promote human rights in China is the resolve of the CCP. Hard-liners in the party will not tolerate any invasion of their stronghold of power, as the world witnessed in Tiananmen Square. They see sanctions as a capitalist tool designed to undermine China's rapid growth and weaken the CCP's hold on political power. Even if the sanctions disrupted economic life, they would have no lasting effect on China's political system—and may even serve to strengthen the ruling elite's resolve to promote communism at any cost. Closing China off from the outside world by means of sanctions would be more apt to play into the hands of the hard-liners than to overthrow them.

Directors of China's state-owned enterprises would support sanctions, because protectionism always benefits inefficient firms. Strengthening those enterprises would be bad for China and bad for the United States. Rapid export growth to China and investments in China have been due to the growth of the nonstate sector. Sanctions would harm that sector the most and slow export growth.[23]

Political leaders in Taiwan and Hong Kong oppose sanctions against China. They favor delinking trade agreements and human rights, not because they do not care about human rights in China but because they recognize the importance of open markets for the stability and prosperity of the entire Asian-Pacific region. They also understand that trade liberalization is a prudent long-run strategy for promoting human rights in China.

According to an editorial in the *South China Sunday Morning Post* (1995: 10), President Clinton's 1994 decision to delink trade and human rights "was welcomed with a collective sigh of relief." If the United States were to deny China most-favored-nation status, the resulting punitive tariffs would destroy "the Hong Kong-Guangdong partnership, which has been the engine of China's economic growth." Moreover, "the political and economic focus would have shifted back towards the Centre." Human rights in China then would be nipped in the bud as the state sector gained ground and the nascent market sector diminished. Yet, as the *Post* notes, "For all the economic progress trade with the West has encouraged, China remains a harsh political dictatorship."

The final difficulty with using economic sanctions to force China's hand on human rights is that legitimate trade may become politicized as U.S. interest groups use sanctions to protect their markets or further their own political agendas. Rep. Solomon's statement is only the tip

[23]State-owned enterprises accounted for only 20 percent of China's export growth in 1991–92 compared with over 80 percent in 1986–87 (Lardy 1996: 14).

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of the iceberg when it comes to sliding from arguments in favor of human rights to protecting American jobs. The political drive to link China's progress on human rights to U.S. trade policy no doubt would dwindle if the United States were running a trade surplus with China.[24]

In sum, even though one can make a legitimate case for limited sanctions in the case of China, those sanctions are unlikely to achieve their intended results. Indeed, imposing economic sanctions on China to advance human rights and promote democracy is likely to retard both and inflict substantial costs on legitimate traders in China and the United States. The millions of Chinese who now enjoy growing freedom and prosperity in the nonstate sector will be punished by sanctions while the state sector and the CCP gain ground.

A better alternative is to let markets and their supporting institutions evolve in China and keep China open to the outside world. Foreign firms now have more than 120,000 projects operating in China with a total investment of over $135 billion (Melloan 1996). That amount of foreign investment will put pressure on regional and local leaders to protect the market and make the rulers in Beijing reluctant to reverse economic liberalization. Pressure may then mount for eventual political liberalization.

Western companies have already had an impact on China's civil society. They have increased business standards and demanded a legal infrastructure.[25] Continued economic liberalization is sure to raise business standards further and help cultivate an institutional infrastructure based on the rule of law. The changes will occur first in the nonstate sector (especially in the southern coastal provinces) and then spread throughout China as competition and openness become the norm.

The best strategy for the United States is to take steps to move China toward a market-liberal order. What China needs is a new system and a new way of thinking about human rights. Economic sanctions, as my colleague William Niskanen says, are rather like strategic bombing—they miss the main target but claim many innocent victims. Human rights will come to China only when property rights

[24]Using the U.S. trade deficit with China to bash China is politically expedient. The fact that U.S. consumers gain from cheap imports goes by the board in the political pursuit of protecting American industry and big labor. The $34 billion figure used to depict the U.S. bilateral trade deficit with China is itself suspect. Nicholas Lardy of the Brookings Institution estimates a trade deficit with China of $22 billion. Beijing has estimated the deficit to be closer to $10 billion when full account is taken of transshipments through Hong Kong (Greenberger 1996).

[25]See Rep. Philip Crane's discussion of how U.S. firms increase standards in less developed countries (U.S. Congress 1995: 153).

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are treated as fundamental civil rights and when civil rights are protected by law. As Harry Wu, a former political prisoner in China, wrote in the *Washington Post* (26 May 1996), "Until private ownership is allowed on a wide scale, genuine liberalization—representative government, free markets and individual rights—will remain elusive" in China.

Creating a Market-Liberal Order

To depoliticize economic life, China needs constitutional change and new thinking (*xin si wei*). Chinese scholar Jixuan Hu (1991: 44) writes, "By setting up a minimum group of constraints and letting human creativity work freely, we can create a better society without having to design it in detail. That is not a new idea, it is the idea of law, the idea of a constitution."

As the world's leading constitutional democracy, the United States should spread its ethos of liberty by keeping its markets open and by extolling the principles that made it great. America should not play the dangerous game of pitting human rights activists against free traders. American prosperity and global prosperity are better served by open markets than by well-intended economic sanctions. History has shown that the best route to freedom and prosperity is market liberalism not market socialism. China should be admitted to the World Trade Organization as soon as possible and be given unconditional most-favored-nation trade status, which should be renamed "normal trade relations."

Governments everywhere need to get out of the business of trade and leave markets alone. Western democratic governments, in particular, need to practice the principles of freedom they preach and recognize that free trade is not a privilege but a right.

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Bureaucratic Corruption in Africa: The Futility of Cleanups

John Mukum Mbaku

Recent interest in the political dimension of economic growth has had a significant impact on the study of the behavior of bureaucrats and how their activities affect macroeconomic performance. Most of the research has been devoted to the study of bureaucratic compensation (Kimenyi 1987; Mbaku 1991a; Couch, Atkinson, and Shughart 1992) and bureaucratic corruption. Little attention, however, has been given the problem of corruption cleanups.

An effective cleanup program can be designed and implemented, but only if the researcher puts bureaucratic corruption in the right context. Unless it is understood that bureaucratic corruption is opportunistic (rent-seeking) behavior and is related to the scope and extent of government regulation of economic activities, cleanup programs are unlikely to succeed. This study examines bureaucratic corruption and cleanup strategies in Africa and seeks to advance the public-choice approach as the most effective and intellectually sastifying framework for corruption cleanup.

In Africa, bureaucrats attempt to increase their level of compensation by lobbying lawmakers and politicians and by engaging in other activites to influence the political system and maximize benefits accruing to them. Many civil servants also illegally increase their compensation by providing services to interest groups that seek favors from the government. Political coalitions seeking ways to subvert the existing rules to redistribute national income and wealth in their favor can achieve their objectives by bribing civil servants whose job is to enforce state regulations and implement national development plans. If

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bureaucrats discover they can earn more income from providing services to groups seeking state favors than from their regular (public) jobs, they may pay more attention to the demands of such interest groups than to the proper enforcement of state laws and regulations and the effective implementation of national development plans. In societies where civil service compensation levels are relatively low, a significant part of the public employee's total compensation may be derived from engagement in outside activities, resulting in a significant increase in bureaucratic corruption (Mbaku 1991a).

The rules that regulate socio-political relations in a country have a significant impact on the ability of civil servants to seek and secure (either legally or illegally) outside income. In nondemocratic societies, as has been shown by Mwangi Kimenyi (1987), bureaucrats are less constrained in their employment of public resources to lobby legislators and influence those individuals with direct responsibility for determining levels of compensation for the public sector. In fact, in many African countries, most civil servants are members of the politically dominant group and have significant influence over the allocation of resources. Under these conditions, civil servants behave like interest groups whose primary objective is to put pressure on the political system in an effort to redistribute wealth to themselves.

In countries with poorly constructed, inefficient, and non self-enforcing constitutional rules, opportunistic behaviors (including rent seeking) are usually quite pervasive. In such countries, the rules that regulate socio-political interaction have failed to adequately constrain the government. As a result, state intervention in private exchange is equally pervasive. Excessive regulation of economic activities creates many opportunities for rent seeking, including bureaucratic corruption.

Corruption has been an important subject of analysis by social scientists for many years. In the 1960s, however, two major events rekindled interest in the study of corruption, especially in developing countries. First, the development by Samuel Huntington (1968, 1990) and others of theories of modernization and political development renewed discussions on bureaucratic corruption and the role of laws and institutions in economic growth and development (Leff 1964, Huntington 1990, Myrdal 1990). Second, the economies and markets of the newly independent countries of Africa and Asia were overwhelmed by corruption, bureaucratic inefficiency, and incompetence. Since the early 1960s, researchers have devoted significant effort to the examination of bureaucratic corruption in the developing economies, paying much attention to the effects of the behavior of civil servants on economic growth and development (Heidenheimer, Johnston, and

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LeVine 1990). Despite this emphasis on the study of corruption in post-independence Africa, there has been insufficient attention paid to the problem of corruption cleanup in Africa.

The Concept of Corruption

Corruption in developing countries is often believed to arise from the clash or conflict between traditional values and the imported norms that accompany modernization and socio-political development. Bureaucratic corruption is seen by some researchers, then, as an unavoidable outcome of modernization and development (Alam 1989, Bayley 1966). David Bayley (1966: 720) argues that "corruption, while being tied particularly to the act of bribery, is a general term covering the misuse of authority as a result of considerations of personal gain, which need not be monetary." Herbert Werlin (1973: 73) defines political corruption as the "diversion of public resources to nonpublic purposes." In Africa many people see corruption as a practical problem involving the "outright theft, embezzlement of funds or other appropriation of state property, nepotism and the granting of favours to personal acquaintances, and the abuse of public authority and position to exact payments and privileges" (Harsch 1993: 33). Joseph Nye (1967: 419) argues that corruption involves "behavior which deviates from the normal duties of a public role because of private-regarding (family, close clique), pecuniary or status gain; or violates rules against the exercise of certain types of private-regarding influence."

Jacob van Klaveren believes that a corrupt bureaucrat regards his office as a business from which he is able to extract extra-legal income. As a result, the civil servant's total compensation "does not depend on an ethical evaluation of his usefulness for the common good but precisely upon the market situation and his talents for finding the point of maximal gain on the public's demand curve" (Klaveren 1990: 26). As part of his definition of corruption, Nathaniel Leff (1964: 8) includes "bribery to obtain foreign exchange, import, export, investment or production licenses, or to avoid paying taxes." According to Carl Friedrich (1990: 15), individuals are said to be engaging in corruption when they are granted power by society to perform certain public duties but, as a result of the expectation of a personal reward or gain (be it monetary or otherwise), undertake actions that reduce the welfare of society or damage the public interest.

Bureaucratic corruption provides civil servants with the opportunity to raise their compensation above what the law prescribes. Through the practice of corruption, private entrepreneurs are able to capture

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and maintain monopoly positions in the economy. Politicians, who serve as wealth brokers, obtain the resources they need to purchase security and continue to monopolize the supply of legislation. The biggest loser from corruption is society as a whole. Corruption allows inefficient producers to remain in business, encourages governments to pursue perverse economic policies, and provides opportunities to bureaucrats and politicians to enrich themselves through extorting bribes from those seeking government favors. Thus, corruption distorts economic incentives, discourages entrepreneurship, and slows economic growth (Mbaku 1992, Gould 1980).

In examining bureaucratic corruption in Africa, it is important to discuss the supply side. Unless entrepreneurs and groups seeking government favors supply the bribes, then most bureaucratic corruption would be limited to nepotism, illegal levies, and the illegal appropriation of public resources. In African countries, payments from entrepreneurs seeking state favors represent an important source of extra-legal income for civil servants. A society's laws and institutions have a significant impact on the level of bureaucratic corruption. State regulatory programs can place a significant burden on business enterprises and entrepreneurship and encourage investors to seek ways to minimize these state-imposed costs. Most intervention schemes, of course, create rents that are usually competed for through a political process. Paying bribes to civil servants has emerged as an important method to compete for those rents. For profit-maximizing enterprises faced with ruinous government regulations, bureaucratic corruption can be viewed as a survival mechanism (Mbaku 1992, Harsch 1993).

It is important to distinguish between political and bureaucratic corruption. While the latter involves efforts by civil servants to enrich themselves through illegal means, the former is used by political coalitions to capture the apparatus of state or maintain a monopoly on power. Political corruption usually includes activities such as vote-rigging, registration of unqualified, dead, or non-existent voters, purchase and sale of votes, and the falsification of election results (Goodman 1990).

David Osterfeld (1992: 204–18) has argued that in a heavily regulated economy, one can find two distinct types of corruption: "expansive corruption," which involves activities that improve the competitiveness and flexibility of the market; and "restrictive corruption," which limits opportunities for productive and socially beneficial exchange. This latter type of corruption, Osterfeld (ibid.: 209–10) argues, is characterized by redistribution of income and wealth in favor of individuals or groups. Most public-sector corruption falls in the restrictive category

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and involves illegal appropriation of public resources for private use (e.g., outright embezzlement by a civil servant) or the illegal use of an individual's public position for his own personal enrichment. Public-sector corruption hinders the proper functioning of the market system, retards economic growth, and thus is restrictive corruption. As examples of expansive corrruption, Osterfeld (ibid.: 212–17) mentions the bribing of judges, politicians and bureaucrats by members of the private sector. The payment of bribes to the right officials, he argues, can help mitigate the harmful effects of excessive government regulation and improve economic participation.

Although certain types of corruption may have beneficial economic and political effects, corruption can permit inefficient firms to remain in business indefinitely. Contrary to Osterfeld's (1992: 213) claim, the firms offering the highest bribes are not necessarily the most economically efficient ones but the ones that are efficient at rent seeking. Indeed, in a study of the Yucatan, Margaret Goodman (1990: 642–43) found that corruption did not benefit efficient producers, but instead protected incompentent entrepreneurs. The firms that survived under institutionalized corruption were those that had become efficient at rent seeking, not at properly and effectively servicing their markets. The expertise that improved their ability to survive was their knowledge of the political process, who to bribe, and how to effectively manipulate the political system to their advantage. In addition, Goodman found that corruption in the Yucatan did not ensure new groups or entrepreneurs opportunities to enter the market. Instead, corruption allowed the old and more established groups to totally dominate and monopolize markets.[1]

The primary emphasis in this paper is on the type of corruption that involves the purchase of state favors from bureaucrats who have been charged with the job of formulating and implementing national development plans, enforcing state regulations, and protecting private property rights. Thus, activities of interest include payment of bribes to obtain import and export licenses, foreign exchange permits, and investment and production licenses. To minimize costs imposed on their enterprises by the state, owners of capital may bribe civil servants and other members of the enforcement community in order to receive favorable tax treatment. Civil servants are also able to extort bribes

[1]For a thorough examination of challenges to the pro-corruption arguments, see Goodman (1990) and Leff (1964). Despite the taxonomy for corruption provided by Osterfeld (1992), corruption, regardless of the type, is a serious problem for most developing countries and should be minimized. The latter can be accomplished, as discussed in this article, through proper institutional reforms.

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from individuals and groups seeking access to government-subsidized goods and services. The resources expended by entrepreneurs on bribes represent an illegal tax on economic activity and can be viewed as an attenuation of property rights. In many African countries, incumbents do not seem to be genuinely interested in effective cleanup programs because corruption represents an important source of revenue and a means through which incumbents channel resources to supporters and to elites who use the threat of violence to extract rents (Mbaku 1992, 1994).

What Causes Bureaucratic Corruption in Africa?

Much research has been done to determine the causes of bureaucratic corruption in Africa. According to David Apter (1963), African civil servants may be obliged to share the proceeds of their public offices with their kinfolk. The African extended family places significant pressure on the civil servant, forcing him to engage in corrupt and nepotic practices. Bureaucrats are believed to exploit their public positions to generate benefits for themselves, their families, and their ethnic or social cleavage. Thus, in studying corruption in Africa, researchers have tended to place emphasis on the structural and individual conditions that contribute to corrupt behavior. Investigators have identified several structural factors that contribute to bureaucratic corruption in Africa. One such structural factor is the "soft state" that is said to embody "a weak or diffuse sense of national interest and the absence of a commitment to public service" (Gould and Mukendi 1989: 434). Many researchers have argued that there appears to be an absence of a commitment to public service among citizens of many developing countries and that excessive levels of bureaucratic corruption in these economies are related to the lack of devotion to serving the public interest. In many African countries, civil service employees view public service as an opportunity for self enrichment. Pita Agbese (1992: 229–30) has observed that in post-independence Nigeria, all political coalitions and groups have been engaged in determined efforts to capture the apparatus of state in order to use the state's redistributive powers to amass wealth for themselves. Soon after capturing the government, the incumbent regime usually erects significant barriers to entry and monopolizes the supply of legislation, thus making certain that other groups do not participate in the allocation of resources. For locked-out groups, participation in the economic systems must be obtained through payment of bribes to incumbent bureaucrats, all of whom are members of the politically dominant group.

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Nigeria is not the only country in Africa in which the apparatus of government has become an instrument for the enrichment of members of the politically dominant group. South Africa, long regarded by many scholars in the West as a bastion for free enterprise in Africa, has for many years promoted laws that allowed the white minority to use the redistributive powers of the state to enrich itself while sentencing the black majority to perpetual poverty and deprivation (Hazlett 1988; Mbaku 1991b, 1993; Williams 1989; Doxey 1961; Hutt 1964). Throughout Africa, from Algeria to Zaïre, bureaucrats and politicians promote perverse economic policies, which while impoverishing most of society, provide concentrated and significant benefits to the national elites and interest groups.

Incompetence and inefficiency among civil servants have been given as other institutional issues associated with bureaucratic corruption in Africa. Sustainable economic and social development requires an efficient and professional civil service. To effectively carry out national development plans and promote entrepreneurship and innovation in the economy, the government bureaucracy must be responsive to the needs of the entrepreneurial class. Additionally, public goods and services should be delivered efficiently. The implication is that the nation's civil service must be competent and possess a significant level of professionalism. Hiring decisions should be based on merit and qualification, and senior positions should be awarded only to candidates who have distinguished themselves and possess the ability and expertise to efficiently perform the duties assigned them. Civil service positions should not be used as rewards for political support or swapped for bribes, or used to meet obligations to one's ethnic cleavage. Incompetent, unqualified, and unprofessional civil servants contribute significantly to failures in development and force the country to remain essentially underdeveloped.

Shortly after independence, many African countries adopted statism as their development model. This approach to resource allocation emphasized state control and eventually turned many African governments into major economic units. Today, African governments are the primary investors, exporters, importers, and bankers. In addition, the state also employs a significant proportion of the national labor force and is quite involved in income redistribution. Through a series of regulations and statutes, the state is able to extract wealth from the poorly organized rural farm sector for use in subsidizing the relatively well-organized and politically volatile urban sector. In many African countries the beneficiaries of excessive state intervention in private exchange have been public employees whose job it is to enforce the laws. Control of an enormous amount of public resources by

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bureaucrats has allowed them to manipulate public policies to amass wealth for themselves at the expense of the rest of society. In several instances, bureaucrats have created artificial shortages in order to extort bribes from prospective demanders. The enforcement of state regulations and statutes in most African countries is poor, arbitrary, capricious, and ineffective. As a consequence, individuals and groups affected by the regulations are forced to engage in opportunism, including the payment of bribes to civil servants. Several scholars have cited the transformation of the post-independence African state apparatus into an instrument for the enrichment of members of the politically dominant group as a significant contributor to corruption (Agbese 1992, Ihonvbere and Ekekwe 1988).

Pervasive and chronic poverty, extremely high levels of material deprivation, and severe inequalities in the distribution of resources also have been advanced as major determinants of corruption in the African countries (Leys 1965). Many regions of the world have made significant advancements in economic and human development during the past 40 years. Yet Africa has remained essentially poor and severely deprived. Evidence shows that Africa is today the poorest region of the world (UNDP 1990, 1995). The emergence of the African military, in the post-independence period, as an important force in the allocation of resources has further distorted income distribution. In many African countries, the armed forces receive a disproportionate share of the public budget. It is argued by many researchers that these post-independence developments have contributed significantly to increased corruption, underdevelopment, and pervasive poverty and deprivation (Mbaku 1994).

Some scholars believe that corruption in Africa and other developing regions arises from the existence of defective cultural norms and behaviors (Jabbra 1976). Other researchers believe that corruption in Africa is related to the clash between traditional and foreign norms that accompany modernization and industrial development. As such, corruption is seen as an unavoidable consequence of economic modernization and political development (Alam 1989, Bayley 1966).

In the majority of developing societies, individual rights are often subordinate to the rights of the group or social cleavage. As a result, loyalty to the ethnic group is considered more important than individual rights or personal accountability. In Africa, these particularistic attachments are quite strong and have been cited as important determinants of bureaucratic corruption. Individuals who become successful in the public sector or the exchange economy are expected to share the benefits with their extended family and their ethnic cleavage. Thus, a civil servant may engage in corrupt activities in an effort to

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meet personal obligations to members of his family or ethnic group (Alam 1989, Gould and Mukendi 1989).

In contrast, public choice theory contends that bureaucratic corruption is related primarily to government control and regulation of economic activities. Once constitutional rules have been selected and adopted, and a government established, political coalitions will try to use government to redistribute income and wealth in their favor. Unless the adopted rules effectively constrain the ability of the government to supply special-interest legislation, rent seeking will become pervasive as groups seek ways to enrich themselves at the expense of the rest of society. At the same time, civil servants will be able to extort bribes from entrepreneurs seeking ways to minimize the burden of state regulations on their enterprises and attempting to enter economic sectors closed by state intervention in markets.

Most Africans live in societies with weak, inefficient, and poorly designed constitutional rules, which provide the government with almost unlimited power to intervene in private exchange. In such economies, resource allocation is totally politicized and the civil service has replaced the market as the principal instrument for the allocation of resources. Civil servants are aware that lucrative monopoly rights created by government regulatory activities provide their owners with enormous monopoly profits. As a result, bureaucrats try to capture rents by extorting bribes from entrepreneurs who request them. Where government regulation imposes significant costs on a business, the entrepreneur can minimize those costs by paying bribes to members of the enforcement community. The bribe is expected to either exempt the business from the laws or to have the individual's enterprise taxed at a lower rate. If these restrictions on economic activity are eliminated, bureaucrats would be unable to extort bribes from entrepreneurs. Thus, bureaucratic corruption is primarily rent-seeking behavior, which is directly related to the level and extent of government activity in the economy (Mbaku 1992).

Traditional Strategies for Corruption Cleanup

The literature on corruption cleanup identifies four types of strategies to minimize or eliminate corruption. They include societal, legal, market, and political strategies (Gillespie and Okruhlik 1991: 80). Societal strategies place emphasis on the determination of a common standard of morality against which corrupt behavior can be measured. Vigilance by members of society and education to make it relatively costly for individuals to engage in corruption are also emphasized (Dobel 1978, Etzioni-Halevy 1979, McMullan 1961). It is believed

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that bureaucratic behavior can be constrained effectively by the law; special commissions of inquiry or special prosecutors can be chosen to investigate individuals and groups accused of corruption; and, where the evidence gathered points to corruption, the judiciary system can judge and punish the guilty according to national laws (Padhy 1986, Ali 1985). Market-related strategies for the cleanup of corruption are based on the belief that there is a relation between the structure of the market and the incidence of corruption. The prescribed remedy is less government regulation and greater reliance on markets for the allocation of resources. Such an approach, however, appears to emphasize the manipulation of outcomes within existing rules instead of proper reform of the rules. The fault is not with the market, but with the rules that regulate the market. Since rules define market outcomes, greater reliance on markets for the allocation of resources without reforming existing rules will have little effect on outcomes, including bureaucratic corruption. Unless there is effective reform of the socio-political rules within which the market functions, incentives for opportunism will remain and corruption will continue unabated (Bayley 1966, Macrae 1982, Rose-Ackerman 1978, Tilman 1968).

Political strategies for corruption cleanup emphasize the decentralization of the public sector. It is argued that corruption arises from the concentration of power in the hands of a few politicians and bureaucrats, and that a process which provides citizens with greater access to public institutions will significantly minimize opportunities for corruption within the country. Under this approach, an effective cleanup program is expected to emphasize political deregulation and the subsequent expansion of opportunities for citizens to participate in governance. Social scientists and policymakers who favor administrative reform as a way to minimize the incidence of corruption support increasing the legal compensation of bureaucrats in order to reduce the chances that civil servants will seek extra-legal income (Gillespie and Okruhlik 1991; Dobel 1978; Nas, Price, and Weber 1986; Wade 1982).

The impetus to clean up corruption can be provided primarily by political exigency rather than by genuine interest in the efficient functioning of the nation's political and economic institutions. In several countries, including those in Africa, postcoup commissions of inquiry are usually designed to discredit the ousted government and help incoming elites gain recognition and legitimacy. Incumbents also use cleanup programs to help them stay in power and continue to monopolize the supply of legislation and the allocation of resources. An incumbent leader faced with deteriorating economic and social conditions and a challenge from opposition parties or groups may

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initiate a campaign to clean up corruption within his administration in an effort to direct attention away from existing problems and the government's inability or unwillingness to provide effective solutions for those problems. Whether or not corruption cleanups are used for political exigency and how often is determined by several factors—including "the personal values of the head of state, challenges from a counterelite, and popular discontent arising from socioeconomic conditions" within the country (Gillespie and Okruhlik 1991: 82).

In several African countries, politicians regularly use cleanup campaigns to help them stay in power. Cleanup programs can be used to discredit members of a previous regime, to destroy the reputations of leaders of the opposition, and to improve support among the population for the incumbent regime. Even if a government seriously and honestly wishes to clean up corruption, existing approaches suffer from at least one obstacle: their success depends on the effectiveness of the counteracting agencies. In Africa cleanup programs depend primarily on the police, the national judiciary, and the press, and assume that those agencies are appropriately constrained by the law and are free of corruption. In addition to the fact that few African countries have a press that is independent and free of government manipulation, the police and national judiciary systems of most African countries are pervaded by very high levels of corruption. As a result, a cleanup program backed by those agencies is unlikely to be effective. Present cleanup programs are based on the manipulation of behaviors within what are inefficient rules and as a result, are unlikely to be effective. The first step in an effective cleanup program is to select appropriate new rules, making sure that the new social contract is capable of generating the outcomes desired by society.

The Public-Choice Approach to Corruption Cleanup: The Importance of Rules

Geoffrey Brennan and James Buchanan (1985) argue that the rules that regulate the activities of individuals within a society matter and are a major determinant of how individuals and organizations behave. The behavior of bureaucrats and the entrepreneurs who bribe them can be analyzed effectively only within the context of existing rules. Thus, without a clear understanding of a country's laws and institutions, any effort to analyze or understand corruption within that society would be futile. Any cleanup program that is designed without taking into consideration the impact of existing rules on the behavior of individuals (including bureaucrats, entrepreneurs, voters, and politicians) within the society would be ineffective. Rules define how indi-

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viduals can interact with each other, provide a means for the settlement of conflict, and generally place constraints on individual behavior, as well as that of the group and collectivity (Brennan and Buchanan 1985).

Effective rules allow individuals to pursue their private ends in such a way that they do not infringe on the ability of others to do the same. The rules that regulate socio-political interaction can be explicit (e.g., a written constitution) or based on custom and tradition. Given an existing set of rules, corruption can be viewed as opportunistic behavior on the part of individuals or groups. In this vein, corruption can be seen as a problem of constitutional maintenance that can be handled appropriately only through rules reform.

In an effort to explain the relevance of rules, Brennan and Buchanan (1985: 13) return to the "tragedy of the commons," an illustration that is used quite often in economics. If, for example, the rules of a society require that agricultural land be owned communally, and farmers are assumed to be utility maximizers in the traditional sense, then overgrazing will be the outcome. The overgrazing is not a result of market failure, as is often assumed, but a problem associated with the nature of the rules that regulate socio-political relationships in this society, including the behavior of farmers. In other words, given the existing rules, utility maximization will lead to overgrazing. As is the case in many African societies, policing is usually the method employed to minimize the problem of overgrazing. Unfortunately, in the absence of privatization and appropriate institutions to protect and enforce property rights, efforts to force certain outcomes within the existing set of rules are rarely successful.

Present cleanup programs in Africa suffer from several problems. First, they are being carried out within inefficient and nonviable rules. Second, corruption cleanup involves efforts to manipulate outcomes within existing rules through policing. Third, the counteracting agencies charged with policing and enforcement of the laws and the bureaucrats who work in those agencies are not properly constrained by the laws. Finally, many bureaucrats are themselves corrupt and cannot be counted on to provide the leadership needed to run effective cleanup programs. Thus, effective corruption cleanup needs to begin with rules reform to make certain that the outcomes generated within the rules are those desired by society.

Efforts to clean up corruption would be futile if the rules that regulate socio-political relations provide an incentive system that makes opportunism highly lucrative. If, as a result of the adopted rules, rent-seeking activities, as opposed to genuine entrepreneurship, are highly rewarding, entrepreneurs are likely to devote most of their time and effort to rent seeking. In such a case, using the police force

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to prevent individuals from taking advantage of lucrative rent-seeking opportunities is unlikely to be effective, especially if members of the police are corrupt and inefficient. Again, the fundamental problem is the absence of a rule of law, not the corrupt outcomes. Thus, appropriate procedures for effective control of rent seeking and other opportunistic behaviors, including bureaucratic corruption, is to reform the rules of the game and change the incentive system.

Dealing with corruption and other opportunistic behaviors, according to public choice theory, is a problem of constitutional or rules maintenance. Besides corruption, opportunistic behavior includes shirking, adverse selection, moral hazard, and free riding (Ostrom, Schroeder, and Wynne 1993: 43–72). Even if individuals select an efficient set of rules (i.e., rules that generate mutual gains for all parties), opportunistic behavior (including corruption) would still be a problem for the post-constitutional society. Making certain that opportunism is minimized in the post-contractual society requires an efficient and effective enforcement system to ensure cooperation and compliance. Unfortunately, third-party enforcement of constitutional rules is usually unreliable, inefficient, and not particularly viable. Some scholars have suggested that the national judiciary and police be allowed to serve as counteracting agencies to enforce compliance and minimize opportunism. Those institutions, however, are themselves subject to interest-group pressure. In addition, in most African countries, those institutions are not properly constrained by the law and are pervaded by high levels of corruption. Consequently, the national judiciary and police are not appropriate instruments for corruption cleanup or enforcement of constitutional rules (Lowenberg 1992, Lowenberg and Yu 1992, Wagner and Gwartney 1988).

The problem of rules maintenance has been examined by several researchers. Emerging from these studies is a theory of constitutional maintenance whose main objective is to find ways to minimize opportunism in the post-constitutional society (Anderson and Hill 1986, Buchanan and Faith 1987, Aranson 1988, Niskanen 1990). It is generally believed that making the constitution or the set of rules selected *self-enforcing* will eliminate most opportunities for rent seeking and other opportunistic behavior. A constitution can be made self-enforcing by endowing it with principles and procedural rules that introduce, maintain, and enhance political and economic competition in the post-constitutional society. In other words, during constitutional negotiations, the rules are designed to make both political and economic markets competitive and accessible to all members of society. An important characteristic of a self-enforcing set of rules is its ability to constrain government and limit the exercise of government agency.

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If the state's ability to intervene in private exchange is constitutionally restrained, political coalitions will find it very difficult to engage in inefficient redistributions. Constitutionally constraining the ability of the government to engage in ex-post resource redistributions will significantly limit redistributions of income induced by majority vote and rent seeking. Once the constitution limits the ability of the state to redistribute income and wealth, interest groups are unlikely to invest in rent seeking, because such investments would either yield relatively meager returns or be unprofitable.

In addition to extorting bribes from individuals and groups seeking government favors, bureaucratic corruption includes the illegal appropriation of public resources by civil servants, nepotism, illegal taxation, and other illegal activities designed to increase the compensation of bureaucrats above the legal limit. Not all of these activities, however, qualify as rent seeking. Paying of bribes by an entrepreneur to a civil servant in an effort to lower taxes is a form of bureaucratic corruption and is also rent-seeking behavior. Although the illegal appropriation of state resources by a bureaucrat for his personal use is bureaucratic corruption, it is not rent seeking. If, however, civil servants lobby legislators in an effort to secure additional privileges for themselves, this behavior is rent seeking, but is not generally considered a form of bureaucratic corruption. To effectively minimize all the above forms of behavior, there must be real reform of existing rules.

Rules and Corruption Cleanup in Africa

Most African countries today operate under constitutional rules that were adopted at independence. Despite many attempts at post-independence rules reform, most African countries have not succeeded in designing appropriate laws and institutions, especially those that would guarantee the types of outcomes desired by members of society. Instead, what pass as constitutions in many African countries are basically adaptations of European constitutional models that have allowed politically dominant groups to continue to maintain a monopoly on power.

The institutions brought to the African colonies by the Europeans were primarily "structures of exploitation, despotism, and degradation" (Fatton 1990: 457). As argued by Michael Crowder (1987: 11–12), "the colonial state was conceived in violence rather than by negotiation." Thus, the rules established to regulate socio-political relations in the African colonies were not the outcome of negotiations among representatives of relevant population groups in those societies. Instead, those rules were imposed by Europeans and designed to satisfy their desired outcomes.

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When it became evident that the colonies would be granted independence, the colonialists quickly developed a reform program that was unable to fully address fundamental issues related to the effective participation of the indigenous peoples in post-independence development. Robert Fatton (1990: 457) states that these last-minute reform efforts failed to allow for "fundamental transformation in the economic, cultural, or bureaucratic domains." Thus, the Europeans left behind rules and institutions that were weak and potentially unstable.

Most of the constitutional rules that African countries adopted at independence were developed abroad with the interests of the indigenous peoples represented by urban elites, most of whom had been educated in Europe and had accepted Western political norms and beliefs. In addition to the fact that these urban elites were not well informed on conditions in the rural sectors of their countries, they usually had objectives and interests that were significantly different from those of their peasant countrymen. Since the design of rules often excluded a significant part of national political opinion, the documents adopted were not efficient.[2]

Many African countries later abandoned the rules that they had adopted at independence and undertook constitutional reforms in an effort to design more efficient and appropriate rules. Unfortunately, constitutional discourse was still limited to a few urban elites with a significant part of national political opinion excluded from participation. In some countries, governance was by military decree with the constitution suspended. In fact, several African countries (including Ghana, Zaïre, Nigeria, Libya, and Somalia) have been ruled by military elites during most of their existence as sovereign nations.

In addition to the fact that constitutional discourse was dominated by urban elites, the process did not seriously consider the aspirations, desires, and needs of the rural populations, and the people were not enfranchised and provided the facilities to participate effectively in the selection of rules. In South Africa (until 1994), participation in rules selection was limited to whites (Cowen 1961). The constitutional rules produced by post-independence efforts produced Leviathan states, whose redistributive powers were used by political coalitions to amass wealth for themselves while impoverishing the rest of the

[2]See, for example, Cowen (1961) for a discussion of how the majority black population was excluded from the development of the first constitution of the Union of South Africa. For a discussion of the first constitution of the Republic of Cameroon (the former French Cameroons), see LeVine (1964). Note that in addition to the fact that the Republic of Cameroon's first constitution was practically a copy of the constitution of the French Fifth Republic, the UPC party, the largest indigenous political party in the colony, was eliminated from participation in the design of constitutional rules.

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people. Many Africans today live under rules that were not unanimously agreed upon by the relevant population groups within each country or by their representatives. To ensure that the outcome is an efficient set of rules, agreement must be unanimous and must be achieved voluntarily.

Since post-independence attempts at rule reform have failed to produce more efficient constitutions, the last several years have witnessed a tremendous increase in levels of bureaucratic corruption in Africa.

Conclusion

The purpose of this paper was to reexamine corruption cleanup strategies in Africa and seek to show why they have been ineffective. African countries, like many developing countries, have tried several strategies in an effort to minimize levels of bureaucratic corruption. These include societal, legal, market, and political strategies. All those approaches to corruption cleanup represent the manipulation of outcomes within a given set of rules and presuppose the existence of efficient counteracting institutions. The evidence shows, however, that most judiciary systems and police forces in the African countries are not properly constrained by the law and that most civil servants (including judges and police officers) are themselves corrupt. As a result, most cleanup programs in Africa have been unsuccessful.

Bureaucratic corruption is an outcome generated within a given set of rules. An effective normative evaluation of such an outcome can only be undertaken after a thorough understanding of the rules that generate the outcome. Thus, to understand why people engage in corruption requires an examination of the rules that regulate the socio-political behavior of individuals. Since these rules determine how individuals behave and relate to each other, they also determine the outcomes to be generated in the post-contractual society. Thus, effective corruption cleanup should not involve efforts to manipulate outcomes within rules. Instead, an effective approach should involve reform of existing rules and the subsequent selection and adoption of new rules that can generate the outcomes desired by society. Since the rules determine the incentive system that will prevail in the post-contractual society, society can effectively impose the outcomes it wants through rules design. For example, the problem of overgrazing of agricultural lands can be minimized by establishing private property rights in land during rules selection. Usually, the establishment of political rules and a political order precede the establishment of an

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economic order. The rules of political order include the "definition of the rights of persons, [and] can be legitimately derived only from the agreement among individuals as members of the polity" (Brennan and Buchanan 1985: 26). The rights of persons are not defined by the government. Instead, individuals or members of society form governments to protect and guarantee their rights as defined and agreed upon in the social or constitutional contract. Any attempt by the government to modify or abrogate those rights invariably violates the basic rules. It is important to note that problems of control in the post-constitutional society do exist. In establishing the polity, the government is granted the power to monopolize legitimate force. Once established, government may try to exceed the limits of the authority delegated it by the people—and if it does, it may render itself illegitimate.

Gary Becker (1994: 18) remarked that "corruption is common whenever big government infiltrates all facets of economic life, never mind the political and business systems." If the country's rules make the political system the primary determinant of firm profitability, then entrepreneurs are likely to devote most of their resources, including their time, to rent seeking. For example, if state subsidies, discretionary tax relief, and other forms of regulations—instead of managerial expertise, business acumen, and competition—become the primary determinants of the profitability of firms, rent seeking, including bureaucratic corruption, would become pervasive. Entrepreneurs in such an economy will devote a significant portion of their activities to lobbying and bribing politicians and civil servants in an effort to maximize profit levels.

Given the incentive system provided by existing rules, legal strategies and other forms of corruption cleanups are unlikely to be effective. In addition to the fact that manipulating outcomes within the rules is not an effective way to secure the outcomes desired by society, these strategies can only function effectively if the counteracting agencies and those who manage them are properly constrained by a rule of law and are free of corruption. Many of the police officers and judges who are called upon to cleanup corruption are themselves beneficiaries of the corrupt system of resource allocation. It is unlikely that those individuals will perform their jobs effectively. An effective corruption cleanup strategy must fundamentally weaken the link between the government and the economy. That is, the relationship between firm profitability and the state must be severed. The most effective way to achieve that objective, and thus guarantee the outcomes desired by society, is rules reform.

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THE PARADOX OF THRIFT: RIP

Clifford F. Thies

Perhaps the single most destructive tenet of Keynesian economics was its denigration of saving. Keynesianism has been used to justify wasteful spending, massive deficits, and one after another scheme to redistribute wealth from those who would save it to those who would spend it.

In keeping with this anti-saving doctrine, during the Christmas selling season of 1991, then President Bush made a big to-do of buying a pair of woolen socks at a suburban shopping mall to try to stimulate consumer spending. And, during his first year in office, President Clinton referred to every increase in spending that he proposed as an "investment."

But things are changing. The 14th edition of Paul A. Samuelson's *Economics*, a textbook that popularized Keynesian economics and has been coauthored with William D. Nordhaus since the 12th edition, does not even mention the so-called paradox of thrift. Instead of disparaging saving, this edition contains an extensive discussion of the low U.S. saving rate and a comparison of that rate to the much higher saving rates in Germany and Japan. Probable reasons for the low U.S. saving rate are given as deficit spending, social security, relaxation of restrictions against consumer borrowing, and a decline in the Protestant ethic (Samuelson and Nordhaus 1992: 444–46).

To the extent that Samuelson's *Economics* chronicles the evolution of mainstream economic opinion, one can say that Keynesianism—and its concern with the paradox of thrift—has now come to an end. At this juncture, it is useful to review what exactly was the Keynesian revolution in economics and why the paradox of thrift is no longer in vogue.

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Keynesian Anti-Thrift Doctrine and the Anti-Thrift Doctrine of Keynes

The paradox of thrift refers to how—in the Keynesian model of the economy—an increase in saving reduces production and employment. This supposedly occurs because a decrease in spending leads to a decrease in employment, which leads to a further decrease in spending, which leads to a further decrease in employment, which leads to a yet further decrease in spending, and so on. Thus, if people try to increase their saving, there will supposedly be a decrease in spending, and a fall in employment and production. Furthermore, as a result of the interaction of what the Keynesians call the "multiplier" and what they call the "accelerator," an increase of intended saving supposedly may result in a decrease in actual saving.

As Samuelson (1958: 237) writes in an early edition,

> It is a paradox because in kindergarten we are all taught that thrift is *always* a good thing. Benjamin Franklin's *Poor Richard's Almanac* never tired of preaching the doctrine of saving. And now comes a new generation of alleged financial experts who seem to be telling us that black is white and white is black, and that the old virtues may be modern sins.
>
> Let us for the moment leave our cherished beliefs to the side, and try to disentangle the paradox in a dispassionate, scientific manner.

This discussion remained more-or-less unchanged through many later editions.

Samuelson's number one textbook rival, Campbell R. McConnell (1960: 261–62), put it much the same way in his first edition:

> By attempting to increase its rate of saving, society may create conditions under which the amount it can actually save is reduced. This phenomenon is called the paradox of thrift. . . .[T]hrift, which has always been held in high esteem in our economy, now becomes something of a social vice.

This wording has continued through McConnell's most recent editions.

To be sure, certain textbook writers avoided, or tried to make sense out of the paradox of thrift. George LeLand Bach (1966), whose textbook was somewhat more conservative than Samuelson's, presented the Keynesian multiplier model. But, possibly because "personal saving has been a stable percentage of disposable income in peacetime prosperity" (ibid.: 83), he does not bring up the issue of the paradox. Armen Alchian and William R. Allen (1972: 560), whose textbook was perhaps the most market-oriented of its time, argued: "We may resolve the so-called paradox of thrift by recognizing that

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this decreased desire for consumption at all levels of income was associated with an *increased demand to accumulate money holdings*." That is, in keeping with Say's (and Walras') Law, an excess demand for fiat money must correspond to an excess supply of goods and services.

An interesting thing about the paradox is that it is not to be found in Keynes' *General Theory* (1935). Keynes was indeed opposed to saving. He considered saving to be a social harm, and advocated policies to encourage spending and discourage saving. In particular, he argued that "up to the point where full employment prevails, the growth of capital depends not at all on a low propensity to consume but is, on the contrary, held back by it" (ibid.: 373).

Keynes did not, however, connect underemployment *to shifts in* consumption spending. He connected underemployment to *a low level of* consumption spending via the "secular stagnation" hypothesis. Supposedly, because of past economic growth there came to be a chronic excess of what planned saving would be at full employment over what investment would be at full employment. This hypothesis was massively contradicted by the post-World War II economic expansion, and has been long abandoned by Keynesian economists.

Keynes considered the consumption function to be relatively stable. Under normal conditions, shifts in "the propensity to consume out of a given income" were not considered to be of more than secondary importance (ibid.: 110). This point is made by Alvin H. Hansen (1953: 84), one of Keynes' most loyal followers. So why did the early Samuelson and other textbook writers make such a big deal out of the paradox of thrift?

Several reasons can be cited, first among them being rejection of the past. According to Harry G. Johnson (1978: 189), part of the appeal of Keynesianism was that it was "an intellectual realm in which youthful iconoclasm could quickly earn its just reward (in its own eyes at least) by the demolition of the intellectual pretensions of its academic seniors."

A second reason the paradox of thrift made its way into the textbooks is the elastic nature of Keynesianism. *The General Theory* is widely acknowledged to be wrong in many of its most important assertions, as well as being disorganized, confusing, and self-contradicting. As to "how did it happen that a book so full of obscurities, contradictions, confusions, and misstatements was hailed as one of the great works of the Twentieth Century," Henry Hazlitt (1960: 9–10)—a critic of Keynes—put it bluntly: "as with the works of Hegel and Marx, the very mystification added to the book's prestige. Unintellibility was assumed to be a mark of profundity." Samuelson (1964: 316)—an admirer of Keynes—writes:

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> It is a badly written book, poorly organized; any layman who, beguiled by the author's previous reputation, bought the book was cheated of his five shillings. It is not well suited for classroom use. It is arrogant, bad tempered, polemical and not overly generous in its acknowledgements. It abounds in mares' nests and confusions. . . In short, it is a work of genius.

Because *The General Theory* is such a poorly written book, "there is," according to Axel Leijonhufvud (1968: 35), "room. . .for differing interpretations of Keynes." Indeed, Leijonhufvud argues that if his interpretation is not what Keynes meant to say, it's ". . .what he should have said." Samuelson (1964: 316) writes that "there is reason to believe that Keynes himself did not truly understand his own analysis."

The methodology of Keynesian economics is hardly restrictive. With minor additions and adjustments, its typical equations can be used as the basis of a classical, a monetarist, or a supply-side model. Robert Clower and Leijonhufvud (1975: 183) argue that there is no end to "the Keynesian model's capacity for mischief." Thus, Keynesian economics evolves over time, easily discarding whatever it is that Keynes said, and whatever it is that passed for Keynesian economics at one time or another.

A third reason for incorporation of the paradox of thrift into the textbooks was mathematical sophistry. Keynesian economists are known to love mathematical models that impress their audiences and that allow them—like a magician pulling a rabbit out of a hat—to produce from their models amazing "facts" challenging their audiences' prior beliefs.

In economics, mathematical models are usually justified not so much because they are realistic, but because of their efficiency in illustrating something considered to be important. That is, a trade-off is often involved between the realism lost and the clarity gained in the simplifications made when designing mathematical models. As a result, mathematical models that do a good job of illustrating something of importance might be silent or even misleading about other things.

But Keynesian economists tend to treat their mathematical models as objects to be studied in their own right; either believing their models to actually be realistic, or being more interested in teaching their methodology than in teaching economics. Quirks such as the paradox of thrift are given center stage in Keynesian textbooks because only someone trained in the cabala of Keynesian economics would know that an increase in saving would decrease production and employment.

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Mr. Keynes and Wage Rigidity

It was John R. Hicks (1937) who put Keynes' economics into mathematical form in his famous article "Mr. Keynes and the Classics." He developed the "IS-LM" model showing how, in the Keynesian system, fluctuations in aggregate demand effect national income and employment. Hicks' formulation revealed that Keynesian economics rested fundamentally on the inflexibility of certain wages and prices, which he referred to as "fixprices" (also see Modigliani 1944). Keynes did not break with classical economics in identifying monopoly power as a source of macroeconomic instability—for classical economists also accepted that doctrine. Classical economists argued against the corn laws that protected domestic agriculture, grants of monopoly power to industry, and prohibitions against workers freely entering into unions. Keynes broke with classical economics, however, in arguing that the government *should accommodate* prices and wages that were high due to monopoly power, rather than resist monopolization of the economy.

Keynes' most loyal followers both agreed and disagreed. Dudley Dillard (1948: 24–26), for example, while admitting that Keynes recognized the need to accommodate union wage-setting, nevertheless argued that Keynes' contribution was more fundamental, dealing with the failure of interest rates to clear the money market, the irrational expectations of business executives, the durability of fixed capital, and the "peculiar aspects" of a monetary economy.

This contradictory doubleness of thought concerning price stickiness continues to this day. Certain "New Keynesians" (e.g., Ball et al. 1988 and Mankiw 1990) have recently developed what they call the microfoundations of price rigidities. Because there are costs involved in setting prices, and because many markets are characterized by monopolistic competition, changes in *nominal* demand can lead to fluctuations in *aggregate* employment and output. And, following a change in nominal demand, some time may be required for entry and entry-deterrence to reestablish something approaching macroeconomic equilibrium.[1]

Commenting on this latest twist of Keynesian economics, James Tobin (1993: 48), the doyen of Keynesianism, agrees that Keynes "would have done better to assume imperfect or monopolistic competition throughout the economy." Yet Tobin (ibid.: 26) insists that Keynesian economics "neither asserts nor requires nominal wage and/or price rigidity."

[1]This theory hardly seems capable of explaining the Great Depression.

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According to Tobin (ibid.: 49), "classical unemployment" occurs when jobs are limited because of excessive real wage rates imposed by government or trade union regulations. Unemployment, says Tobin, would be best dealt with by removing those barriers to competition. "Keynesian unemployment," on the other hand, is that unemployment that can be eliminated by increased aggregate demand that erodes high real wages through inflation and that increases production and employment. Differentiating one from the other, Tobin admits, "is sometimes difficult." Exactly!

Not all Keynesians insist on making the mystic distinction between wage-price rigidity and Keynesian economics that Tobin makes. Samuelson (1964: 332) writes,

> Had Keynes begun his first few chapters with the simple statement that he found it realistic to assume that modern capitalistic societies had money wage rates that were sticky and resistant to downward movements, most of his insights would have remained just as valid.

Robert Lekachman (1964: ix) is clear enough:

> The Keynesian critics who argue that Keynes' doctrines of underemployment equilibrium depend on assumptions of wage and price rigidity, no doubt score important *theoretical* points. . . . The practical importance of their achievement is small, for every advanced western society is characterized by institutional barriers against declining commodity prices and labor incomes.

Thus, Keynesian economics is based on the premise that *the way to* deal with unemployment is by increasing aggregate demand, rather than by attacking "the institutional barriers" resulting in wage and price rigidity. It rests on the curious idea that those with the political clout necessary to protect their monopoly advantages are not smart enough to figure out the effects of inflation.

Keynesianism and the High Wage Doctrine

It must be pointed that the Keynesian presumption that wages are "sticky downward" melded nicely with the prevailing economic hearsay of the 1930s—i.e., the "high wage doctrine" (see Krooss 1970: 90–91). The high wage doctrine incorrectly identified the high wages that were *the result of* the economic prosperity of the 1920s to have been *the cause of* the prosperity. Thus, at the outbreak of deflationary pressure during the Great Depression, the Hoover administration encouraged the maintenance of high wages; the deflationary pressure took its toll by reducing production and employment rather than by reducing wages and prices.

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Given these circumstances, once the recession turned ugly, resort to aggregate demand management may have been the only practical thing to do. Indeed, it is a "myth. . .that Keynes alone among leading economists had advocated public works in the Depression" (Demand 1988: 1). Lionel Robbins and Friedrich Hayek—who, in accord with the Austrian theory of the business cycle, initially advocated allowing deflation and the liquidation of the malinvestment to run their course—both later accepted this course of action.

Even W.H. Hutt and Ludwig von Mises—two of the most severe critics of Keynesian economics—both eventually, but still reluctantly, accepted at least the inevitability of deficit spending. Hutt (1979: 414) referred to Keynesianism as "a theory which provided a justification for what may have been *politically expedient*." And Mises (1966: 793) wrote:

> We may admit that for the British and American governments in the 'thirties no way was left other than that of currency devaluation, inflation and credit expansion, unbalanced budgets, and deficit spending. Governments cannot free themselves from the pressure of public opinion.

Nevertheless, Mises argued that office-holders should resign rather than implement such policies.

William Röpke (1963: 222) granted that "it can happen. . ., that all efforts to put a quick end to unemployment prove useless, so that recourse must be had to an increase of 'effective demand'." Yet he was very critical of Keynes' justification of deficit-spending and inflationism as a general rule. Even worse than fueling the demagoguery of politicians, he criticized the intellectual arrogance of Keynesianism: "We find in the teachings of Keynes the social philosophy of a man who, proud of his alleged modernity and progressiveness, believed himself capable of 'making over' society and the economy" (ibid.: 227).

This assessment of what was essential about Keynesian economics is shared even by some of Keynes' admirers. Alan Coddington (1983: 1) wrote, "At the most fundamental level, what distinguishes Keynesian policies is that they take a utilitarian view of the public finances." Keynesianism denies "the idea that there may be precepts of 'sound finance,' or financial 'propriety,' 'rectitude,' 'responsibility,' and so on" (ibid.: 3).

The paradox of thrift simply took Keynesian economics to its illogical conclusion. If governments should increase their spending during recessions, why should not households? If there were no principles of "sound finance" for public finance, from where would such principles come for family finance? Eat, drink and be merry, for in the long-run we are all dead.

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The Keynesian revolution was about overthrowing the doctrines of balanced budgets and sound money, free international trade, and laissez-faire economics, and adopting instead the doctrines of deficit spending, inflation, and the managed economy. Adherence to the tried and true was to be replaced by trust in the new, self-confident generation of macroeconomists, who were not to be constrained by old-fashioned precepts, but who were to be free to do as they knew best.

According to Keynes (1935: 371), underconsumptionists prior to him, such as Thomas R. Malthus, "preferred to see the truth obscurely and imperfectly rather than to maintain error." In this one sentence, Keynes implied both that his intellectual opponents—the classical economists—preferred to maintain error and that he saw the truth clearly and perfectly. This kind of arrogance made Keynes famous; he wrote in the self-confident style of the demigods of the modern era.

Concerning Keynes and the textbooks, Samuelson (1964: 316) wrote, "Finally, . . .the Keynesian analysis has begun to filter down into the elementary textbooks; and, as everybody knows, once an idea gets into these, however bad it may be, it becomes practically immortal." If true, the *removal* of the paradox of thrift from Samuelson's 14th edition of *Economics* offers an estimate of the "practical immortality" of Keynesianism.

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Error and Bias in Benefit-Cost Analysis: HUD's Case for the Wind Rule

Louis De Alessi

In July 1994, the U.S. Department of Housing and Urban Development (HUD) put into effect new regulations—the "wind rule"—that set stricter wind resistance standards for the construction of manufactured housing (HUD 1994a).[1] HUD presented the economic rationale for the wind rule in its *Regulatory Impact Analysis of Improved Wind Standards for Manufactured Housing* (RIA), which claimed that asymmetric information and externalities had resulted in market failure (HUD 1994b: 21). According to HUD, the wind rule would yield annual benefits of $83.8 million at annual costs of $51.7 million (ibid.: 1); the RIA estimates that the cost of an average single-section manufactured house, which sold for $20,877 before the wind rule, would increase by $1,492 in Wind Zone II and $2,119 in Wind Zone III, and that 56 percent of the increase would be passed on to consumers through higher prices.

The RIA is deeply flawed by errors of omission and commission. First, HUD fails to offer any evidence that asymmetric information affects adversely consumers' choices[2] or that externalities exist; it also

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[1]The wind rule amends the National Manufactured Housing Construction and Safety Standards Act of 1974. The new regulations follow closely the standards proposed by the American Society of Civil Engineers in ASCE 7-88 (ASCE 1990). Manufactured houses are the direct descendants, usually larger and without wheels, of mobile homes.

[2]Consumers may not fully understand the technical characteristics of competing products and yet, as *they* see it, have enough information—including information about the reputation of firms along the production-distribution chain—for making choices. Moreover, although producers may have more information about their products, buyers have more information about how they are going to use them.

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fails to recognize the limits of benefit-cost analysis. Second, HUD's analysis and computations contain mistakes that systematically bias the results toward more government regulation. For example, HUD uses the wrong formula to calculate the proportion of the cost increase that falls on consumers and fails to shift the demand curve to reflect the claimed increase in quality; correcting just the first of these errors would raise the incidence on consumers from 56 percent to as much as 99 percent. In estimating benefits (foregone damages), HUD confuses expenditures with costs. Correcting this error would cut the estimate of private benefits by two thirds, from $52.3 million to $17 million; public benefits presumably would be cut by a similar amount. In estimating costs, preliminary reports (Keefe 1995) suggest that private costs, as predicted by industry sources, are twice HUD's guess (FMHA 1994: 1). Moreover, public costs make no allowance for enforcing the wind rule. Even using HUD's own methodology and disregarding the costs generated by a regulatory regime (e.g., by inept and rent seeking behavior), benefits appear to be a fraction of costs.

The wind rule affects the quality—not necessarily for the better—of manufactured houses (MHs) and raises their prices in Wind Zones (WZs) II and III. It has a substantial, adverse impact on the welfare of many MH consumers, producers, retailers, and park owners; it also yields unintended consequences, including reduced competition within the MH industry.

Following a reminder about the limits of benefit-cost analysis, this paper provides some highlights of the wind rule, examines the MH industry for signs of market failure/externalities, notes some of the errors in HUD's benefit-cost analysis, and offers an explanation for the wind rule. There is no attempt to offer a "correct" estimate of the benefits and costs of the wind rule.

Limits of Benefit-Cost Analysis

Individuals making a choice compare the benefits and costs of the alternatives that they have selected for consideration, minding their own circumstances of time and place (Hayek 1948).[3] Thus, the issue is not benefit-cost analysis: the issue is who does it and what does it mean under alternative ownership and transaction cost conditions.

In a private property system with low transaction costs, the value that an individual attaches at the margin to a unit of a commodity is

[3]The benefit of an option is the value of the desirable consequences less the value of the undesirable consequences perceived by the chooser; the cost of an option is the value of the next best alternative foregone (Alchian 1968). The individual making the comparison chooses whether to apply a rough rule of thumb or undertake a more detailed analysis.

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roughly equal to the market price.[4] Prices are useful precisely because they measure value at the margin, providing individuals with the information and incentive to shift resource rights from lower- to higher-valued uses. Market prices, however, do not reveal the value that an individual attaches to inframarginal units.[5] As a result, an outside observer cannot measure objectively the total costs and total benefits of a choice (Buchanan 1969).

Individuals deciding the allocation of their own resource rights have an incentive to take account of the resulting economic (value) consequences. The more fully are private property rights defined, assigned, and enforced and the lower are transaction costs, the more fully individuals bear the value consequences of their decisions and have incentive to internalize them. In the limit, private and social costs are the same: there are no external effects (Coase 1960). If transaction costs or legal constraints on private property rights (e.g., government regulation) inhibit the process, externalities may arise, providing individuals with the incentive to evolve new institutional and contractual arrangements to internalize them (Demsetz 1967, Ellickson 1989, Ostrom 1990).

Individuals (e.g., central managers) choosing rules that constrain the allocation of resource rights owned by others respond to a different set of incentives. First, the central managers select the options and characteristics to be considered. These choices are not value-free, and reflect the managers' own preferences and constraints. Second, central managers estimate benefits and costs using market prices that do not reflect the value of inframarginal units and of side conditions. Moreover, the estimating process is strewn with choices that affect the outcome. Third, central managers typically aggregate individual values, making special assumptions about demand functions, losing relevant information, and implicitly assuming that the distribution of benefits and costs does not matter. Fourth, central managers have incentive to massage the data to obtain results consistent with their own preferences and constraints, political and otherwise. Central managers do not bear the value consequences of their decisions (at least not directly, except in the case of bribes) and have incentive to take them into account only as they bear on political and other considerations. Thus, such benefit-cost analyses are biased; their main function

[4]At best (e.g., in equilibrium without corner solutions and side conditions), an individual's marginal rate of substitution between any two commodities is equal to the ratio of their market prices.

[5]The individual making a decision selects the alternatives and characteristics to be considered, forms expectations about consequences, and assigns values. Thus, benefits and costs are subjective: all choices reflect the preferences and constraints of the decisionmaker.

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is to provide a legitimacy of sorts for what the central managers wish to do.[6]

Highlights of the Wind Rule

The wind rule requires that MHs be designed by a professional engineer or architect to withstand winds up to 110 mph in Wind Zone III, which includes coastal sections of Florida, Louisiana, North Carolina, the Hawaiian Islands, and parts of Alaska, and up to 100 mph in Wind Zone II, which includes the rest of Florida and coastal areas of other states bordering the Gulf of Mexico and the Atlantic Ocean (HUD 1994a: 2472). The wind rule does not apply to the rest of the United States.

In addition to raising the overall wind resistance requirements, the wind rule strengthens many individual construction specifications. Stricter standards apply to the manufacture of some structural assemblies, components, windows, connectors, and fasteners and the attachment of roofs and wall coverings to sheathing and framing members. For example, roof, wall, and floor framing must be connected using 28 gauge minimum steel strapping or "a combination of strapping and structural rated wall sheathing that overlaps the roof and floor" (ibid.: 2467). The wind rule also sets up guidelines for state and local authorities to regulate ground anchors and tie-down systems and thus, indirectly, the foundations used to support MHs.

HUD'S General Case for the Wind Rule

The wind rule is designed "to ensure adequate safety and durability with respect to high winds" (HUD 1994b: 1). According to HUD (ibid.: 21),

> The market does not provide adequate safety because of a market failure due to asymmetric information. Consumers are less able to distinguish between manufactured housing units built to high wind safety standards from units built to low standards than are producers. . . . The government, as a disinterested third party, can solve this market failure by certifying units built to high wind safety standards. Consumers trusting the government imprimatur will be willing to pay for additional wind safety to the point where the marginal benefit equals the marginal cost. Because of the externality aspect of manufactured housing units built to low wind safety standards, (i.e., the public costs of low wind safety standards not borne entirely by the consumers of manufactured housing) the government is

[6]Benefit-cost analyses may inhibit those government projects where even the most creative analysts cannot produce benefits greater than costs.

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justified in requiring a wind safety standard whose marginal costs exceed private marginal benefits.

HUD simply asserts the existence and adverse effects of asymmetric information and externalities (e.g., damage from flying MH debris and debris removal). Even if this were true, however, it does not follow that the market has "failed" and that government could do better. Certainly the assertion that government is "a disinterested third party" is disingenuous at best.

HUD's claim might have some superficial appeal if the market were not competitive or if significant externalities could be traced to the size of transaction costs or to limitations in the definition, assignment, and enforcement of private property rights. Even then it would be still necessary to establish whether the results entail a failure or a success and whether central managers could do better. In the present case, the issue is moot: none of these conditions hold.

The MH Market Is Competitive

The existence of an open, competitive market suggests that private property rights are reasonably well defined and enforced and that transaction costs do not block trade. The MH industry is open and competitive at both the manufacture and retail levels. Legal barriers to entry are negligible for both producers and retailers, economies of scale (planned volume of output) are exhausted at small levels of production, and the costs of entering the market by opening a plant or a dealership are small (De Alessi 1981: 208–11). Producers continually enter and exit the market as well as open and close plants; at the end of 1992, there were 97 producers with 227 plants scattered throughout the United States.[7] In 1990 there were about 6,800 dealers, most of whom represented several producers.[8] The MH industry seems highly competitive, and HUD does not claim or offer any evidence to the contrary.

External Effects Are Negligible

In the absence of any supporting evidence, HUD's claim of externalities is not convincing. MHs typically are privately owned and located

[7]The number of firms and plants over the relevant period is (MHI 1996: 23):

	1991	1992	1993	1994	1995
Firms	85	97	93	98	92
Plants	216	227	244	269	285

[8]Memo dated 2/18/94 to the author from Edward R. Mack, Jr., Florida Manufactured Housing Association. According to a 1974 survey, about 75 percent of the dealers represent 3 or more manufacturers and 41 percent represent 5 or more (Owens-Corning 1975: 29).

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in dedicated parks whose private owners have the incentive to supply the environment demanded by their customers. Different parks provide different kinds of amenities, including degrees of protection from external effects. There are differences in the foundations and anchor/tie-down systems, the sizes and quality—including wind resistance—of MHs, the distances between units, and so on. MH owners choose a site with the combination of attributes that suits them best, including protection from wind damage. After a hurricane, of course, some may wish that they had chosen otherwise.

HUD did not measure the actual damage attributable to external events, let alone the damage—if any—exceeding the amount (implicitly) allowed for in the contract for using a site. And the cost of removing MH debris, essentially kindling, is much smaller than HUD's estimating procedure implies.[9]

Consumers Have Adequate Information

HUD asserts that producers are better informed than buyers about MH characteristics and thus—a *non sequitur*—that buyers lack adequate information. The evidence suggests otherwise. Most MH manufacturers typically sell their output through independent dealers who represent from two to five manufacturers and provide customers with a broad range of choices regarding size, quality, and price. In addition, customers typically visit at least four dealerships before making a decision (Bernhardt 1976: 40–43). As a result, even first-time buyers on average are exposed to the products of a dozen manufacturers.

Repeat buyers benefit from their own experiences as well as from those of others, including their neighbors in MH parks. First-time buyers, however, also benefit from the experience of repeat buyers. Buyers typically arrange for a site in an MH park before completing a purchase; accordingly, they visit at least one site and have the opportunity to acquire more information at a relatively low cost from prospective neighbors and MH park managers. In this environment, manufacturers have incentive to provide the kind of MHs that consumers demand and dealers have incentive to inform their customers about product characteristics. Additionally, the typical MH is manufactured locally and interested buyers can visit the plant. There is no indication that consumers lack adequate information.

Of course, it is sufficient that some consumers be well informed. In a competitive market, the choices of consumers at the margin guide the decisions of producers. Repeat and other well-informed buyers

[9]HUD allocates post-disaster relief expenditures to MHs on the basis of the ratio of MHs destroyed to total housing units destroyed (HUD 1994b: 16).

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choose those MHs with the price-quality combinations, including safety and durability, that they prefer. The shifting at the margin of dollar votes toward those MHs that offer a better price-quality combination, as the consumers themselves see it, drives the market. In a well-functioning market there are broad variations in product quality. Some consumers choose to buy lower-priced MHs that are less durable and less safe in a hurricane or tornado while others choose MHs that are more durable and capable of sustaining higher winds. Moreover, consumers need not be knowledgeable about the technical characteristics of a product in order to make informed choices. The reputations of producers and retailers, who act as expert buyers for consumers, provide bonds that assure specific performance and inform consumers.

HUD argues that consumers would be willing to pay the higher price for the higher safety imposed by the wind rule once the information of higher quality is conveyed by government certification that the MHs are built to high wind safety standards (HUD 1994b: 21). As shown below, HUD's own data do not support that statement. If it were true, however, the government could simply certify the wind safety of various MHs and let consumers make their own choices. Although such an arrangement has its own drawbacks, it would impose fewer restrictions on producers' and consumers' choices.

HUD's Inference of Market Failure Is Not Warranted

In an attempt to justify the assertion that asymmetric information resulted in market failure, HUD (1994b: 21) notes:

> Since the estimated private costs and private benefits of increased wind safety are so close, the question arises as to why the market does not provide a comparable level of safety without a government rule. The market does not provide adequate safety because of a market failure due to asymmetric information.

HUD's estimated annual private benefits of $52.3 million and annual private costs of $49.3 million (Table 1) indeed are close.

The evidence developed in this paper, however, suggests a more reasonable explanation for the behavior of consumers: as *they* see it, the additional costs are greater than the additional benefits. Indeed, HUD's own data show that costs either exceed or are trivially less than benefits in three of the four MH categories considered (Table 2). Thus, costs exceed benefits for most buyers, especially low-income families purchasing lower-quality units (the lower is the quality, the more binding is the wind rule and the higher is the cost of meeting it).

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TABLE 1

HUD: TOTAL ANNUAL BENEFITS AND COSTS
(Millions of Dollars)

	Benefits	Costs
Private:		
Consumers	52.3	27.4
Producers	0	21.9
Subtotal	52.3	49.3
Public	30.4	2.4
Reduced Death/Injury	1.1	0
Totals	83.8	51.7

SOURCE: HUD (1994b: 25–29).

TABLE 2

INCREASE IN PRIVATE BENEFITS, COSTS, AND PRICES PER MH

	Wind Zone II		Wind Zone III	
	Single Section	Multi-Section	Single Section	Multi-Section
Private Benefits, HUD	$1,516	$2,062	$2,022	$2,750
Private Costs, HUD	1,492	1,813	2,119	2,722
Increased Prices, HUD	829	1,007	1,177	1,512
Increased Prices, Revised	1,407	1,710	2,100	2,698

SOURCE: HUD (1994b: 15, 21, 24) for HUD's estimates.

HUD's Estimate of Costs and Their Incidence

HUD estimates the wind rule's annual private costs at $49.3 million, with 56 percent shifted to consumers, and annual public costs at $2.4 million (Table 1). These estimates are flawed.

Private Costs

HUD defines private costs as the increase in production costs due to the wind rule; additional costs incurred by MH retailers and park owners are ignored. To obtain this estimate, HUD calculated the additional costs of complying with each provision of the wind rule for each type of MH expected to be sold in each wind zone. Addressing the estimate at this level of detail is beyond the scope of this study. Industry sources, however, predicted that the increase in production costs due to the wind rule would be twice HUD's estimate (FMHA 1994: 1); preliminary market data from Florida bear this out (Keefe

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1995). Moreover, HUD neglects the costs generated by the regulatory process itself. These costs arise from regulatory constraints that are inept or the product of rent-seeking efforts and that inhibit innovation, adaptation to change, and competition.

HUD allocates private costs between consumers and producers based on the estimated price elasticities of the demand for and supply of MHs. The RIA (HUD 1994b: 23) uses the formula:

$$\Delta P = [E_S / (E_S - E_D)] \Delta C = F \Delta C, \quad (1)$$

where ΔP is the change in price, ΔC is the change in construction cost, E_S is the price elasticity of supply, and E_D is the price elasticity of demand. The coefficient $F \equiv E_S/(E_S - E_D)$ summarizes the combined effects of the demand and supply price elasticities and shows the percentage of the additional production costs passed on to consumers.

MH demand and supply price elasticities for WZs II and III apparently were not available. Rather than develop them, HUD simply chose some existing alternatives. In the case of demand, HUD (ibid.: 22) set $E_D = -2.4$ based on three independent studies that reported nationwide MH demand price elasticities of -2.37 (Morgan and Belknap 1982), -2.5 (Gates 1984), and -2.4 (Meeks 1993); the latter covered the period 1961–89. In the case of supply, HUD used the nationwide, long-run supply price elasticity for new, single-family houses of 3.0 estimated by Topel and Rosen (1988) using data for 1963–83 (ibid.: 23).

These demand and supply elasticities yield the coefficient $F = 3/(3+2.4) = 0.56$, indicating that 56 percent of any increase in production costs is passed on to consumers and 44 percent rests on MH producers. Having estimated the total increase in private costs at $49.3 million, HUD finds that $21.9 million would be borne by producers (presumably through a loss in firm-specific capital) and $27.4 million by consumers (Table 1) through higher MH prices (Table 2).

There are several problems, however, with HUD's estimating procedure. Focusing on just two issues, HUD's use of the nationwide price elasticity of supply erroneously assumes that the wind rule applies to *all* MHs, not just those in WZs II and III, while HUD's assumption that the demand curve remains unchanged is inconsistent with its claim that consumers would be willing to pay for the changes required by the wind rule—in HUD's model, the demand curve should increase by the amount of the increase in costs.[10]

[10]There are other problems with HUD's estimating procedures. For example, the RIA does not indicate whether the conditions underlying equation (1) hold. The RIA also makes no effort to establish whether the price elasticity of supply for new, single family houses (which are built on site, subject to weather conditions, by relatively skilled workers) is a good proxy

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Given the supply for the total market, the standard equation for estimating the price elasticity of supply for an individual submarket (McCloskey 1985: 145) is:

$$E_{Si} = (Q/Q_i)\, E_S - [(Q - Q_i) / Q_i]\, E_D, \qquad (2)$$

where E_{Si} is the price elasticity of supply in the *i*th submarket, Q is the quantity sold in the (total) market, and Q_i is the quantity sold in the *i*th submarket; as before, E_S is the price elasticity of the market supply and E_D is the price elasticity of the market demand. The proportion F_i of the increase in production costs passed on to consumers in the *i*th submarket can then be computed using the general formula used by HUD, that is, $F_i \equiv E_{Si} / (E_{Si}–E_D)$.[11]

If the price elasticity of supply is equal to infinity, then a shift in demand has no effect on prices and, for that purpose, can be ignored. The $E_S = 3$ used by HUD is a long way from infinity, and the substantial increase in demand reflecting the claimed increase in quality would occasion a further, substantial increase in prices that HUD does not estimate.

Wind Zone III. HUD reports that 4,200 MHs (2,268 single and 1,932 multi section) were shipped into WZ III in 1992 (HUD 1994b: 23). Using HUD's own estimates of E_S, E_D, and Q_i and total shipments Q = 210,787 in 1992 or 254,276 in 1993 (MHI 1996: 36), the price elasticity of supply is 270 and $F_{III} = 0.99$; that is, 99 percent rather than 56 percent of the cost increase is passed on to consumers in WZ III. The increase in price is 78 percent greater than HUD estimated—even without allowing for the rise in demand due to the increase in MH quality claimed by HUD.[12]

Note that demand and supply price elasticities do not capture dynamic elements, and the RIA does not take into account the rapid

for the price elasticity of supply for MHs (which are built indoors, using assembly-line techniques, by relatively unskilled workers).

[11]Equation (2) is used to derive the price elasticity of supply in WZs II and III, because firms can produce MHs that do not meet the wind rule and sell them outside these zones. The same equation presumably should have been used to obtain the separate nationwide price elasticities of supply for single and multisection MHs *before* deriving the corresponding elasticities in WZs II and III (the incidence on these consumers then would be about 7 to 8 percentage points lower than the revised estimates). The equation $E_{Di} = E_D/(Q_i/Q)$ is not used to obtain the price elasticity of demand in WZs II and III, because buyers in these submarkets cannot buy MHs that do not meet the wind rule. The RIA does not address these and related issues, thus failing to provide an economic rationale for HUD's calculations.

[12]The price increase in Florida might be smaller than elsewhere. Because much of the state is a long peninsula lying within WZs II and III, transportation costs inhibit producers in lower Florida from shifting their sales elsewhere. Accordingly, they would be more likely than manufacturers elsewhere to go bankrupt or bear a higher proportion of the cost increase.

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increase in nationwide MH shipments (presumably demand-driven) that began in 1992.[13] In any case, why should manufacturers incur a loss of several hundred dollars per unit produced for sale in WZ III if they can reduce their losses by shutting down, reducing output, or producing unmodified MHs for sale elsewhere?

Turning to quantity, HUD estimates the change in MHs shipped according to the formula:

$$\Delta Q = (\Delta C / P) Q E_D F, \quad (3)$$

where ΔQ is the change in quantity, ΔC is the change in cost, and the other terms are as previously defined. Based on the increase in costs and the price elasticities used by HUD and an incidence of 99 percent, the decrease in MH sales in WZ III would be 78 percent greater than HUD estimated: a drop of 580 single and 341 multi sections rather than 325 single and 191 multi sections (Table 3).[14] These results, of course, would be partially offset by the increase in demand reflecting the increase in MH quality perceived by consumers.

Wind Zone II. HUD reports that 14,631 single and 12,271 multi section MHs are shipped annually to WZ II (HUD 1994b: 23). Using HUD's estimates of E_S, E_D, and Q_i, and total shipments $Q = 210{,}787$ units in 1992 or 254,276 units in 1993, then the price elasticity of

TABLE 3

DECREASES IN QUANTITY OF MH UNITS

	Wind Zone II	Wind Zone III
Single Section:		
HUD	1,477	325
Revised	2,509	580
Multi-Section:		
HUD	808	191
Revised	1,372	341

SOURCE: HUD (1994b: 24) for HUD's estimates.

[13]Compare WZ III shipments of 4,200 units to nationwide shipments and their year-to-year variation, including an increase of 133,219 units from 1990 to 1994 (MHI 1996: 36):

1987	1988	1989	1990	1991	1992	1993	1994
232,598	218,429	198,254	188,172	170,713	210,787	254,276	303,932.

[14]These results are not sensitive to the price elasticity of demand. Letting E_D be as small as -0.24, one-tenth the elasticity used by HUD, or as great as -24, ten times the elasticity used by HUD, changes the incidence of the cost increase by only 1 percentage point in WZ III and 6 percentage points in WZ II.

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supply is 40 and $F_{II} = 0.94$; that is, 94 percent rather than 56 percent of the cost increase would be passed on to consumers. In WZ II, the increase in prices and the decrease in unit sales would be 70 percent greater than HUD guessed; sales would fall by 2,509 single and 1,372 multi sections rather than 1,477 single and 808 multi sections. Again, the increase in demand reflecting the increase in quality perceived by consumers is not taken into account.

A price increase close to the increase in costs makes sense. HUD estimates that producers bear a loss of about $663 per single and $806 per multi section MH sold in WZ II. But producers selling in WZ II also have the option to shut down, reduce output, or sell elsewhere, the latter a real opportunity in the rising market at the time.

General Comments. HUD's estimate of the rise in private costs ignores some important cost-increasing elements. First, the MHs shipped to WZs II and III will be fewer and built to different specifications from those shipped elsewhere. As a result, some of the economies of scale previously available will be lost. Second, plants on average will be located further from MH parks and transportation costs, a significant portion of the full price of MHs, will be higher. Third, fewer firms will produce MHs for WZs II and III, and there will be less competition.

The revised changes in prices and quantities are based on HUD's estimates of private costs. Although it is too early to assess the consequences of the wind rule, some Florida MH manufacturers report that the increase in costs due to the wind rule occasioned an increase in MHs prices of about 20 percent (Keefe 1995).[15] This increase is consistent with the industry's claim that the increase in production costs would be twice HUD's estimate and with this study's suggestion that the full increase in costs would be passed on to consumers. If these findings are correct, then quantities would be substantially smaller than HUD calculated.

Public Costs

HUD reckons public costs as the deadweight loss (putative loss in consumers' surplus) from the fall in MHs sold. If the decrease is greater than HUD estimated, as seems the case, public costs would be correspondingly higher. More to the point, estimates of consumers'

[15]The wind rule has been in place for little more than a year and more data are necessary to control for changes in other variables. For example, in Florida the decrease in supply occasioned by the wind rule is entangled with other events, including an increase in demand due to Hurricane Andrew and a decrease in demand due to changes in the residence requirements of the Canadian health program, which kept more elderly Canadians at home, and an increase in MH insurance rates.

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surplus are subject to theoretical and empirical limitations too well known to justify further discussion.

HUD also implicitly assumes that implementing the wind rule is costless. But there will be costs borne either by taxpayers, increasing public costs, or by consumers through various fees and charges, increasing private costs.

HUD ignores other costs, including the higher cost of temporary housing after a disaster. Following Hurricane Andrew, MHs shipped into WZ II and III were a major source of temporary housing; indeed, many householders moved into MHs placed next to their site-built houses while the latter were being repaired. Because MHs that do not meet the wind rule could not be shipped into WZs II and III, this option would be drastically reduced.

HUD's Estimate of Benefits

HUD considers three categories of benefits: private, public, and those associated with reduced death and injury (Table 2). These estimates will be examined in turn, with the focus on the largest component: private benefits.

Private Benefits

HUD measures private benefits as the decrease in property damage due to increased wind resistance. Property damage is based on data from Hurricane Andrew for "insurance payments to manufactured housing residents provided by Allstate Insurance Company, and the U.S. Small Business Administration (SBA) loans for uninsured losses to housing" (HUD 1994b: 12). "Thirty-three years of annual savings is discounted to the present, summed over all units produced in a year, and compared" (ibid.: 11).[16]

HUD claims that building MHs to the wind rule will reduce wind-caused property damage by 75 percent in WZ II and 83 percent in WZ III (ibid.). Hurricane Andrew, however, was unusually powerful, with sustained wind speeds above 133 mph and gusts to 175 mph, well in excess of the 100 to 110 mph envisioned by HUD in WZs II and III. Using Andrew as a benchmark would overestimate benefits: evidence from the damage that Andrew inflicted on site-built houses suggests that HUD's wind rule would have little effect under such extreme conditions (Fronstin and Holtmann 1994).

A more important point is that using payments by Allstate and loans by SBA confuses expenditures with costs. Allstate insurance policies

[16]The estimate is highly sensitive to assumptions regarding the severity and frequency of storms, the discount rate—HUD used 7 percent (HUD 1994b: 14)—and other matters.

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typically provided coverage well in excess of market value, and SBA loans generally were for new MHs rather than for used MHs of the same vintage and conditions as those destroyed by the hurricane.

Insurance policies can be for Cash Value, Replacement Value, or Stated Value. Under Cash Value, the insurer agrees to pay up to the initial purchase price less depreciation of the MH damaged or destroyed; thus, cash value approximates the market value of the MH. Under Replacement Value, the insurer agrees to repair the MH or replace it, regardless of its age and condition, with a new, like MH. Under Stated Value, the insurer agrees to repair the MH or replace it with a new, like MH, up to the amount stated in the policy.

According to Allstate, two-thirds of its MH policies in Dade County were for replacement value and only one-third were for cash value, the method implicitly assumed by HUD.[17] In addition, some claims were fraudulent and many payments were generous.[18]

Because the benefits from the wind rule reflect damage foregone, they must be based on actual damage. According to HUD (1991), in 1991 the median MH age was 13 years for owner-occupied units and 17 years for renter-occupied units. As a rough approximation, suppose that the average age of the MHs destroyed by Hurricane Andrew was 15 years. Next, let a 15-year-old single section MH sell for $6,000,[19] its new replacement sell for $20,877,[20] two-thirds of Allstate's policies be replacement value and one-third be cash value. Then Allstate on average would pay out $15,918 [=($20,877 x 2 + $6,000)/3] and HUD would report benefits of $11,939 [=$15,918 x 0.75] in WZ II and $13,212 [=$15,918 x 0.83] in WZ III. The average opportunity cost of the MHs destroyed, however, is $6,000 and the corrected benefits would be $4,500 [=$6,000 x 0.75] in WZ II and $4,980 [=$6,000 x 0.83] in WZ III. Thus, HUD overestimates private benefits by a factor of 2.7.

SBA loans were for new MHs. Here, HUD would overestimate private benefits by a factor of 3.5 (e.g., $20,877 x 0.75 / $4,500). Even using HUD's coefficients for the reduction in property damage occasioned by the wind rule, correcting HUD's confusion of expenditures with costs suggests that HUD overestimates private benefits by a factor between 2.7 and 3.5.[21]

[17]Telephone conversation of 2/21/94 with Mr. Jeff Kucera, Allstate Insurance home office, North Brook, Illinois.

[18]Insurance adjusters who processed Andrew-related claims in Florida were compensated partly on the sizes of the claims. They had incentive to be generous.

[19]In 1992, the market value of a 15-year-old single section MH was $6,000 or less (estimate provided by the Florida Manufactured Housing Association, February 1994).

[20]This is the market price used by HUD for a single section MH (HUD 1994b: 24).

[21]The relationship between the replacement and market values of MHs presumably reflects the relationship between the replacement and market values of their contents.

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Public Benefits

HUD measures public benefits as the reduction in government expenditures for emergency housing, disaster relief grants to individual families, and debris removal attributable to MHs. The proportion of total expenditures allocated to MHs is based on the ratio of MHs destroyed to total housing units destroyed (HUD 1994b: 16). This procedure is flawed: among other things, a destroyed house leaves a great deal more debris than a destroyed MH. More fundamentally, it again confuses expenditures with costs, overstating benefits.

As in the case of insurance payments and SBA loans, government expenditures are not a good estimate of the appropriate economic costs. Many government expenditures are simply transfer payments, and their reduction does not represent a reduction in costs. If the overstatement of public costs is similar to that for private benefits (and could well be greater), correcting this error would also reduce HUD's estimate of public benefits by two-thirds.

Benefits of Reduced Death and Injury

The estimated benefits of the reduction in death and injury from reduced wind damage to MHs are relatively small. Given HUD's track record, presumably they are overestimated.

Distributional Effects of the Wind Rule

Aggregate benefits and costs provide no information regarding the distribution of gains and losses. In general, the costs of building to meet the wind rule are higher for lower-quality MHs (higher-quality MHs already meet some of the new standards) while the associated benefits are lower (users of these MHs cast their dollar votes for lower-quality). Even using HUD's procedures and data, lower-income MH users lose.

HUD nods at the issue in the subsection "Distributional Impact" (HUD 1994b: 33–34). HUD argues that the estimated price increase of a single section MH is a relatively small percentage (3.9 percent in WZ II and 5.6 percent in WZ III) of the yearly median income ($21,052) of MH owners, and concludes that only a few lower-income users will be adversely affected. Using the corrected data would double or even quadruple these percentages.

Looking at median income, however, avoids the issue. For example, 20 percent of all MH owners have incomes of less than $10,000. For these individuals, the price increase for a single section MH represents 8 to 14 percent (8 percent using HUD's estimated incidence, 14 percent using the revised incidence) of their income in WZ II and

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12 to 21 percent in WZ III. Moreover, 16 percent of all MH renters have incomes of less than $5,000. For these individuals, the price increase for a single section MH represents 17 to 28 percent of their income in WZ II and 24 to 42 percent in WZ III. Owners and renters of multi section MHs are affected even more. If costs are greater than HUD's estimate—twice as much according to industry estimates—all these percentages are correspondingly higher.

Furthermore, it is not very useful to compare the increase in price, a stock, to annual income, a flow. Using the revised incidence, the average price of a single-section MH in WZ III would increase by 10 percent (=$2,100/$20,877) and by much more for lower quality units. Thus, actual and imputed rentals would increase by at least 10 percent and possibly as much as 20 percent. MH renters, especially those with incomes less than $5,000, would take a real hit. And many prospective MH owners would be priced out of the market. HUD either does not fully recognize the problem or is trying to ignore it.[22]

Effect of the Wind Rule on Product Quality and Competition

HUD claims that the wind rule will improve the quality of MHs. Presumably it will improve their wind resistance, but it will not necessarily increase their overall quality. The increase in MH prices will force consumers to reduce their consumption of other commodities, including MH quality characteristics not covered by the wind rule or other regulations. As a result, MH prices may not rise as much as expected but the overall quality of some new units marketed in WZs II and III will deteriorate as consumers see it.

The overall quality of the stock of MHs in WZs II and III almost surely will decline. In the normal course of events, as MHs age and wear out they are replaced with newer units. Because new MHs are now substantially more expensive, there will be incentive to repair older units and maintain them in service longer. Paradoxically, one effect of the wind rule is to generate, at least over the near term, a population of older MHs that is less resistant to strong winds.

The wind rule also will reduce competition in WZ II and III. Before the wind rule, producers in WZ I could enter WZs II and III without modifying their units. Segmenting these markets reduces competition with the usual consequences.

[22]HUD also ignores the geographical diversity of MH owners and renters and the resulting differences in response. For example, in Florida many MHs are the winter residences of out-of-state retirees, while in the Carolinas many MHs are the permanent residences of low-income families, typically black.

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Why the Wind Rule?

Without the public component, HUD's benefit-cost analysis hardly supports the wind rule. The weakness of HUD's own case raises the obvious question: why the wind rule? The documentation for the rule, including the RIA, suggests one explanation.

The federal government has adopted a growing range of formal and informal programs, including the Federal Emergency Management Administration and various military support activities (e.g., emergency rations), supposed to benefit victims of disasters. The income transfers resulting from the recent spate of floods, earthquakes, hurricanes, and other natural disasters have turned out to be quite large. Apparently it is politically more expedient to require individuals to take precautions that reduce federal expenditures in case of disaster—a move that would also benefit insurance companies and other special interest groups—than to reduce or eliminate coverage. Once the political process is underway, of course, there is opportunity for various groups—including government agencies such as HUD—to advance their private interests as well as their own view of the public interest.

Conclusion

Benefit-cost analyses conducted by third parties are inherently flawed. Among other limitations, the choices used to structure and conduct the analysis are guided by the preferences and constraints of the individuals managing the analyses rather than by the preferences and constraints of the individuals affected by the rule, and the distribution of gains and losses typically is disregarded. Moreover, such studies simply assume that the proposed rule, as implemented in practice, will work perfectly.

In addition to these flaws, HUD's benefit-cost analysis—even within its chosen frame of reference—is riddled with errors. For example, HUD uses the wrong formula to compute the incidence of private costs and neglects to shift the demand for manufactured homes to reflect the claimed increase in quality (grossly underestimating the incidence on consumers), confuses expenditures with costs (grossly overestimating benefits), and omits enforcement costs. Correcting for just some of these errors suggests that, using HUD's own methodology, the benefits of the wind rule are well below the costs. If the increase in production costs is twice HUD's estimate, as industry sources predicted and preliminary evidence suggests, then presumed benefits are a fraction of presumed costs. Consumers (especially those in the lower income brackets), manufacturers, dealers, and park owners in

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WZs II and III will be worse off. The market will be less competitive and the quality of some MHs may actually deteriorate.

The RIA provides point estimates of costs and benefits. Considering the makeshift nature of the parameters (e.g., price elasticities) used, it would have been particularly useful to examine the sensitivity of the results to small changes in these parameters. Such an exercise would have revealed a substantial probability that, even using HUD's methodology and without correcting any of the errors, the presumed costs of the wind rule would exceed the presumed benefits.

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BOOK REVIEWS

Getting It Right: Markets and Choices in a Free Society
Robert J. Barro
Cambridge: MIT Press, 1996, 191 pp.

It seems that everyone now believes in free markets. Former communists proclaim themselves to be capitalists, the Pope denounces the welfare state, and even President Bill Clinton says the era of big government is over. But why should people believe in free markets? Robert J. Barro, an economics professor at Harvard University, helps answer that question.

"A dominant theme" of *Getting It Right*, explains Barro, "is the importance of institutions that ensure property rights and free markets." He begins with the issue of economic growth, which overwhelming experience demonstrates depends on economic freedom. But rather than stating the obvious, Barro explores a slightly different issue—what political and other national characteristics are also related to prosperity.

Particularly interesting is his analysis of the impact of democracy on economic growth. While economic and political freedom are linked, their relationship is complex. Observes Barro: "More political rights do not have an important impact on growth, but improvements in a broad concept of the standard of living tend strongly to precede expansions of political freedoms." In short, economic freedom, by encouraging prosperity, does more to promote democracy than political rights do to encourage capitalism.

Indeed, Barro warns that as political freedom grows, so does the tendency of the state to meddle in the economy, thereby slowing growth. In some circumstances he finds a slightly *negative* impact of democracy on prosperity: "There is some indication of a nonlinear relation in which more democracy raises growth when political freedoms are weak but depresses growth when a moderate amount of freedom has already been attained." The basic problem is that demands for income redistribution and special-interest privileges tend to rise as a nation's democracy grows more robust. And those policies will slow down growth. Explains Barro, "the required increases in marginal tax rates and other distortions inevitably reduce the incentives for investment, work effort, and growth," while

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special-interest transfers "create economic distortions that hamper growth."

He goes on to review some of the other factors that affect growth rates. For instance, he looks at whether there is an optimal size for a nation. Although he finds "no relation between the growth or level of per capita income and the size of a nation," he concludes that there is a basic trade-off: "a large country is . . . likely to have a diverse population that is difficult for the central government to satisfy," which may lead to the creation of interest groups that lobby the government to redistribute income. Smaller countries, on the other hand, tend to be more open to international trade and more homogeneous, which means that there is less pressure on the government to redistribute wealth. His main conclusion thus may be that smallness, per se, provides no impediment to a country to experience sustained economic growth—provided that country remains open to international trade. But, again, that is also one of the conditions for large countries.

Intermixed with his economic analysis are thoughtful musings about the appropriateness of secession, including in America. He supposes that Washington's reflexive opposition to secession in other countries in part reflects an unwillingness "to reconsider whether the enormous cost of the Civil War in terms of lives and incomes was worth it." As he rightly observes, the conflict was much more over union than slavery. Was the originally unintended elimination of the odious practice nevertheless sufficient to justify the conflict? No, he answers: "Everyone would have been better off if the elimination of slavery had been accomplished by buying off the slaveowners—as the British did with the West Indian slaves during the 1830s—instead of fighting the war." Rare is it to find economic analysis so leavened by sophisticated historical understanding.

It is not only the Civil War where Barro rejects conventional wisdom. While the United States and other Western governments spent most of the 1980s pressing banks to restructure and reschedule the debt of Third World states, Barro contends that such de facto defaults harmed the international credit markets, and thus, ultimately, the borrowing states. Writes Barro: "Instead of encouraging defaults and easy bankruptcies, the best thing that the U.S. government could have done for world development over the past twenty-five years would have been to use all legal means, including seizures of foreign goods, to ensure the repayment of legitimate international claims. It is only this kind of tough enforcement policy by lenders that ensures access to credit by poor countries (or poor individuals)."

Barro also devotes a great deal of attention to financial and monetary policy, with an emphasis on Latin America. Argentina and Mexico, he observes, involve "two countries that began on similar paths but then moved in very different directions." Whereas Mexico's approach to monetary policy continues to be highly discretionary and thus unstable, Argentina's currency board has provided an institutional framework for price stability. Barro's advice to central bankers everywhere is "to control nomi-

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nal variables so as to provide for a stable framework within which the private economy gets accurate signals and can therefore make efficient allocations of resources."

Even more intriguing is his comparative analysis of the economic report cards of U.S. presidents and British prime ministers. He rates the politicians on the basis of the change in the misery index—the inflation rate added to the unemployment rate. Of presidents starting with Harry Truman, Ronald Reagan ends up at the top and Jimmy Carter at the bottom. Barro's results for Great Britain, starting with Winston Churchill, are more surprising—Laborite James Callahan is the best, while Margaret Thatcher, who succeeded Callahan, is only seventh out of ten. The much-maligned John Major is number two.

Beyond those serious, lengthy chapters are a series of delightful short essays. What is the leading monopoly in America today, he asks? The Postal Service. Happily for its customers, competition has been steadily eroding its position. Concludes Barro: "Thus, despite past glories, it is hard to be sanguine about the long-term prospects of the post office as a flourishing monopoly."

He writes about tax amnesties and school choice. The latter, he observes, is "a promising way to deliver improved education, especially for children from poor families." He offers a fascinating look at the factors, such as state laws, local unionization, and average Republican Party vote, that influence the decision to privatize public services. He writes about second-hand smoke, the Endangered Species Act, the economics of baseball, and some of his "Chicago School" colleagues.

Only on term limits does Barro go seriously astray. "To economists, term limits sound like minimum wages, rent controls, and similar interferences with free markets. In each case, the government tries to prevent a mutually advantageous trade." But legislative elections reflect political, not economic, decisions; term limits merely adjust the rules of the winner-take-all political game to promote a better result.

Moreover, Barro, for all his economic astuteness, does demonstrate a rather charming political naivete. He seems surprised to find that some of his liberal friends would prefer to make everyone poorer if doing so would reduce income inequality. He observes: "Apparently some people view the presence of wealthy people as similar to environmental pollution. One can only hope that this class-warfare mentality is not the driving force behind most policy decisions in Washington." What, pray tell, does he think is the driving force behind most policy decisions in Washington today?

Nevertheless, *Getting It Right* is a wonderful book. Simultaneously perceptive and readable, it addresses economists and non-economists alike. It should be mandatory reading for those in Washington making the decisions upon which Barro comments.

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A License to Steal: The Forfeiture of Property
Leonard W. Levy
Chapel Hill, N.C.: University of North Carolina Press, 1996, 272 pp.

During the Constitution's ratification debates, a Pennsylvanian writing under the pseudonym "Old Whig" described civil-forfeiture proceedings as "modes of harassing the subject." He recognized that such proceedings "are undoubtedly objects highly alluring to a government. They fill the public coffers and enable government to reward its minions at a cheap rate."[1]

Old Whig's wary assessment of civil forfeiture—the government's practice of seizing property suspected of wrongful use—rings as true today as it did in 1787. Leonard Levy's *A License to Steal* catalogs numerous instances of property seizures that, on almost any scale of justice, amount to criminal behavior by government agencies. Consider, for example, Billy Munnerlyn's fate.

Operating an air-charter service, Munnerlyn flew a passenger, secretly carrying $2.7 million, from Arkansas to California. The DEA seized the passenger's cash and Munnerlyn's Lear jet on suspicion that both were tied to the drug trade. Although charges were dropped against Munnerlyn, the DEA kept his jet. He eventually repurchased his jet, only to find that the DEA had damaged it to the tune of $50,000 in a futile search for drugs. The DEA is not liable for the damages. Munnerlyn declared bankruptcy; he now makes his living driving a truck.

As the title of his book suggests, Levy is as leery as was Old Whig of civil forfeiture. Though uneven, Levy's book exposes the many ways that government abuses civil forfeiture in the name of law enforcement. Liberal readers will cringe at the high-handedness of police who find in forfeiture a loophole for escaping constitutional fetters on government's treatment of the criminally accused. Conservatives and libertarians will grieve for the further erosion in property rights.

Too recent to make it into Levy's book is the Supreme Court's March 4, 1996, decision in *Bennis v. Michigan*[2]—a case further confirming Levy's wariness of civil forfeiture. Detroit police caught John Bennis with his pants down in his car while being serviced by a prostitute. In addition to fining him, Michigan seized the car, which John owned with his wife Tina. Tina Bennis fought to protect her interest in the car. She argued that because she knew nothing of her husband's tryst with the prostitute, the government could not constitutionally take her share of the automobile without compensation. The Court disagreed, holding that Tina Bennis's innocence matters not a whit. Michigan keeps the car free of charge.

Tina Bennis is not alone. Fully 80 percent of people losing property to federal forfeitures are never charged with criminal wrongdoing. Those people are punished without due process of law. That statistic is unsurpris-

[1]"Essays of an Old Whig," in Storing (1981: 28).
[2]116 S. Ct. 994 (1996).

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ing given that under most civil-forfeiture statutes—such as the one in question in *Bennis*—an owner's innocence is no defense to property seizures. If law-enforcement officials have probable cause to suspect that the property was used wrongfully, it is forfeitable regardless of the owner's complicity. But even when the law does provide innocent-owner protection, it does so only half-heartedly. Innocent-owner defenses (when available) allow owners to regain their properties only after proving their innocence. Government does not bear the burden of proving guilt.

To worsen matters, courts are indulgent of government assertions of probable cause. Levy notes that the police "can rely on an informer's tip, circumstantial evidence, and hearsay." Indeed, racial stereotypes are frequently used. Oregon police admit that their drug-courier profile includes Hispanic ethnicity—which explains why "in more than three-fourths of the cases in which the police seized cash yet found no drugs on the driver, the drivers were Hispanic."

That presumption of guilt, combined with federal law allowing law-enforcement agencies to keep the lion's share of forfeited assets, makes civil forfeiture attractive to police. It is profitable to spend less time protecting citizens' property rights and more time sabotaging those rights. Concerning a case in which the DEA seized $66,700 in cash from an innocent man, Levy remarks: "They weren't trying to get criminals off the streets, only the money out of the pockets of suspects."

Despite its title, Levy's book is no diatribe against forfeiture. It is a scholarly treatment of a complicated subject—but a study not without annoying weaknesses. The book just stops; it has no real ending. More substantially, while Levy does an admirable job recounting forfeiture's history, he fails to draw out the lessons that this history offers for contemporary practice.

Historically, civil forfeiture served to avoid jurisdictional difficulties presented by England's growing maritime trade. Civil forfeiture was first used by admiralty courts to punish foreign owners of pirate ships and ships used for smuggling. Those owners were typically beyond the reach of domestic courts. To solve that practical problem, admiralty courts in the 17th century adopted the fiction that captured pirate ships and smuggled goods were the wrongdoers. Such wrongfully used properties were forfeited. Foreign owners thus escaped personal criminal prosecution but still were punished in the form of property losses. Today, by contrast, civil forfeitures are used even when those suspected of wrongdoing are within the jurisdiction of a domestic court. The *Bennis* decision indicates how far the Supreme Court has let civil forfeiture stray from the original understanding of its purposes.

In light of the Court's hands-off attitude toward civil forfeiture, property owners must look to Congress for reform. In the closing chapter, Levy reviews several reform proposals. One of the most attractive is a bill introduced by Rep. Henry Hyde (R-Ill.). The Hyde bill would shift the burden of proof from the owner of seized property to the government. Rep. Hyde would also make law-enforcement agencies liable for damages

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inflicted upon wrongly seized properties, and give property owners 60 (rather than 10) days to contest federal forfeitures. Such reforms are appropriate in a nation whose government allegedly respects citizens private property rights.

More sweeping than the Hyde bill is one introduced by Rep. John Conyers (D-Mich.). The Conyers bill would effectively abolish civil forfeiture by requiring that all property forfeitures follow only upon criminal convictions of owners. Levy prefers Conyers's bill, but supports Hyde's efforts as a step in the right direction.

Of course, any reforms adopted by Congress would rein in only federal forfeiture powers. Citizens would remain subject to abusive state forfeitures, such as the one suffered by Tina Bennis. Consequently, courts ultimately cannot escape their constitutional responsibility to ensure that government does not abuse its forfeiture powers. Most important among these responsibilities is looking past legislative labels to the substance of government action. If the government punishes someone for wrongdoing, the action should be treated for what it is: a criminal prosecution. Allowing government to inflict punitive sanctions under the guise of civil proceedings is too risky for innocent property owners.

As Levy reports, law-enforcement agencies are none too keen to have their forfeiture powers curtailed. Federal and state officers warn direly of criminals getting the upper hand if even modest reforms such as the Hyde bill are enacted. But to argue that the sanctity of property rights should be ignored in the war on crime is to forget the most important sentiment that Pennsylvania's Old Whig shared with other founding-era Americans: an unconstrained government is the most terrifying of all criminals.

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Storing, H.J. (ed.) (1981) *The Complete Anti-Federalist*, Vol. 3. Chicago: University of Chicago Press.

Madison on the "General Welfare" of America: His Consistent Constitutional Vision
Leonard R. Sorenson
Lanham, Md.: Rowman & Littlefield, 1995, 172 pp.

Article I, section 8 of the Constitution confers upon Congress certain enumerated powers and a potentially more sweeping authority to provide for the general welfare, a goal also set forth in the Preamble. For proponents of a limited central government, the General Welfare Clause has

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been a source of great mischief. Interpreted elastically by constitutionalists of the "living document" persuasion, the Clause has helped serve up a gourmand's feast of government programs, regulations, and intrusions that would have been unimaginable to the Framers.

Forty-three years ago, William W. Crosskey of the University of Chicago attempted to set the record straight—to uncover the original meaning of the Constitution and shut down the revisionists who had robbed the document of its stability and permanence. Alas, Crosskey's tome, *Politics and the Constitution in the History of the United States*, published in two volumes in 1953 with a third volume issued posthumously in 1980, only muddied the waters. Worse still, Crosskey managed to tarnish the image of James Madison, until then revered as a paladin in the struggle against encroaching government.

Leonard R. Sorenson, a professor of politics at Assumption College in Massachusetts, has undertaken to rescue us from our rescuer. According to Crosskey, Madison was duplicitous: Publicly, Madison proclaimed that the General Welfare Clause is merely a synonym for the enumerated powers considered collectively, not an independent source of power. But privately, Madison believed that the General Welfare Clause delegates to the Congress plenary legislative power; that the enumeration of specific powers served simply to allocate and assign governmental functions, establish certain procedural limitations, and illustrate some of the powers deemed to be necessary and proper. This alleged difference between Madison's public and private persona is at the root of the so-called Madisonian contradiction.

Sorenson's thesis, based primarily on *Federalist* No. 41, is that Madison regarded the enumeration as defining the objects entailed within the general welfare and the other general clauses that make up the Preamble (*i.e.*, justice, domestic tranquility, common defense, and liberty). But those objects are the broad ends or purposes of the Constitution, not just means or powers. Therefore, states Sorenson, Madison understood the general terms of the Preamble to enlarge the dominion of government beyond the enumeration itself, although not to confer plenary power. Madison's public position, ascribed to him by Crosskey, was that substantive powers are defined by specifying their number, kind, and application. On the contrary, Sorenson's explanation is that (1) Madison perceived the Preamble of the Constitution as prescribing a limited number of limited ends; (2) the enumeration defines those ends more precisely; (3) the general welfare and other clauses that make up the Preamble vest particular powers beyond the enumeration, but only to accomplish the limited ends; and (4) the particular powers thus vested can be identified only through an examination of the enumerated powers themselves, in their relation to the authorized ends.

If that sounds recursive, it is intended to be. Sorenson maintains that the general ends or objects of the Constitution, as specified in the Preamble, define the purposes of the enumerated powers qua powers; but the enumerated powers, in their end-defining dimension, provide more

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specific meaning to the general purposes. Sorenson concludes that the purpose of the enumeration is to define the limited number of objects or purposes that fall within the idea of the general terms. Thus, a proposed new power must promote an object already authorized; that is, the new power must be derived from a general term, which means that it must also have an immediate and appropriate relation to an already enumerated power.

Perhaps an example from Sorenson will help. The Alien and Sedition Acts, under which aliens could be detained or deported, permitted prior restraint of speech and the press. It could be argued that Congress's authority to pass the Acts was entailed within the enumerated power to suppress insurrections—a particular means of providing for the common defense, domestic tranquility, and the general welfare. Madison rejects that formulation on the ground that suppressing an insurrection involves subsequent punishment, not prior restraint; the enumerated power neither explains nor defines any of the general terms in a manner that permits of censorship.

Sorenson weaves his way through *The Federalist Papers* (principally Nos. 39–44), dissecting and analyzing the text with diligence, erudition, and fastidious attention to detail. His work product should and perhaps will have an impact upon our courts, but there are significant obstacles to overcome.

First, the battle over the General Welfare Clause was all but lost six decades ago in *United States v. Butler* (1936) and *Helvering v. Davis* (1937). In *Butler*, the Court struck down the Agricultural Adjustment Act, which taxed processors in order to pay farmers to reduce production. Although invalidating the statute, the Court adopted the Hamiltonian view (almost in passing) that the General Welfare Clause is a separate grant of congressional authority, linked to and qualified by the spending power. Sorenson perceives correctly that virtually all governmental activity involves the expenditure of money; accordingly, there is little difference between Hamilton's view and Crosskey's position that the General Welfare Clause represents a plenary grant of power.

Any doubt remaining after *Butler* as to the scope of the General Welfare Clause was dispelled a year later in *Helvering*. There the Court defended the constitutionality of the 1935 Social Security Act, requiring only that welfare spending be for the common benefit as distinguished from some mere local purpose. Justice Benjamin Cardozo summed up what has become controlling doctrine ever since: "Nor is the concept of the general welfare static. . . . What is critical or urgent changes with the times."

Justice Harlan Stone struck the final blow in *Flemming v. Nester* in 1954, holding that questions concerning the propriety of conditions imposed on spending, and questions concerning the generality of the benefits, were for the Congress to resolve—subject to judicial invalidation "only if the statute manifests a patently arbitrary classification, utterly lacking in rational justification." However disheartening such cases may be to advocates of a narrower and more constraining General Welfare

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Clause, they do reinforce the urgent need for quality research from competent scholars like Sorenson.

The second hurdle for Sorenson is that his scholarship may be more widely referenced by historians than by jurists. Curiously, Sorenson chose as his principal theme the refutation of Crosskey. Writing long after the Supreme Court had done its damage, Crosskey's influence has been marginal. He is cited but three times in Supreme Court majority opinions, and in only one instance has the cited material implicated (tangentially) the General Welfare Clause. To be fair, Crosskey indisputably provided intellectual ammunition for the bad guys and, in that sense, Sorenson's effort to disarm him (and them) is an important part of the ongoing struggle to secure a more propitious climate of ideas.

Third, the focus of that struggle for ideas may have shifted in light of the Supreme Court's 1995 salvo in *United States v. Lopez*. The explosion of federal power under the expansive rubric of the Commerce Clause—arguably more harmful than any aggrandizement traceable to the General Welfare Clause—has at last been scrutinized by the Court. And if the Commerce Clause is ever restored to its rightful role—that of ensuring the free flow of trade among the states—the next campaign may indeed be waged against the Necessary and Proper Clause. Distended by the Court in *McCulloch v. Maryland* (1819), that Clause now allows Congress to employ means in exercising its powers that are merely convenient—neither necessary nor proper. So, while welcoming Sorenson's attack on the modernized General Welfare Clause, one should not be surprised if it is stalled by the allocation of scarce intellectual resources to more exigent projects. At a minimum, friends of liberty will surely find Sorenson's portrayal of Madison more congenial than Crosskey's.

Proponents of a government constrained to exercise only its enumerated powers should not be discouraged if progress is gradual and halting. Sometimes, in order to effectuate radical change without rending the social fabric, we may have to content ourselves with incremental challenges to long-established doctrines. Sorenson has undeniably supplied more than his fair increment. By tracing to Madison a view less conducive to swollen government than the view embraced by the New Deal Court and its successors, Sorenson enrolls on the side of limited government. He is part of the crusade to circumscribe the reach of the feds—even if his vision of Madison would not bind Congress as tightly to the original enumeration as old-line anti-federalists might desire.

Robert A. Levy
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Pop Internationalism
Paul Krugman
Cambridge, Mass.: MIT Press, 1996, 214 pp.

Competitiveness! The word has a somewhat vague macho connotation—a favorite theme of many business writers and some economists.

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Paul Krugman, however, makes a case that competitiveness is almost always a bad guide to international economic policy, more often a cover for subsidy or protection of some industry. This is also the experience and judgment of this reviewer; for years, my standard lecture to business groups has been on "Competitiveness vs. Productivity."

This book includes 13 articles written by Krugman for various audiences, all but one of which were previously published. The one exception is a generally favorable review Krugman had prepared on *Who's Bashing Whom?* by Laura Tyson. The editor of the *New York Review of Books* rejected the review on the basis that "you're criticizing some very prestigious people." (So much for open political debate on the left.)

As with any collection of articles, this set is somewhat redundant, but there are four primary themes: (1) competitiveness is a mindless and dangerous obsession; (2) the decline in manufacturing employment and the real wages of production workers is primarily a consequence of domestic conditions, not increased international trade; (3) NAFTA will have minimal economic effects; and (4) the high growth rates of the "Asian tigers" is primarily due to a rapid increase in inputs and cannot be sustained.

In treating the competitiveness theme, Krugman directs special criticism at his MIT colleague Lester Thurow, whose book, *Head to Head: The Coming Battle Among Japan, Europe, and America*, conveys the false perception that international trade is a zero-sum game. Authors of several other books with a similar geostrategic theme include Jeffrey Garten, Ira Magaziner, and Robert Reich, each of whom was appointed to a senior position in the Clinton administration. Krugman takes these and other authors to task for both confused theory and careless arithmetic.

With regard to the second theme, one should note that the decline in manufacturing employment is a result of relatively *high* productivity growth in manufacturing, both in the United States and other countries. The decline in agricultural employment, of course, has been a consequence of the same condition.

The slow growth in average real wages, in contrast, is primarily due to a *slow* growth of average productivity (plus the increase in nonwage compensation). There remains a serious debate among economists about whether increased international trade has contributed to the decline in real wages (or the increased unemployment) of low-skilled workers in the high-wage countries, because increased trade is expected to lead to an equalization of factor prices. The case for a trade explanation, interestingly, is usually made by labor economists and the opposing case by trade economists. This debate is not yet settled, but the best evidence against the trade explanation is that the relative employment of low-skilled labor appears to have declined in both the sectors most affected by trade and those least affected. It is less clear what has caused the increased variance of wages, and Krugman and other trade economists may be too quick to attribute this condition to changes in technology.

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Regarding NAFTA, one can argue that it is probably worthwhile, but both the advocates and critics of NAFTA overstated their case. Krugman makes an effective case that NAFTA will have no effect on the number of jobs, will have only a small positive effect on average real income and a small negative effect on the real wages of low-skilled U.S. workers, will not hurt and may help the environment and, for the United States, is primarily a foreign policy issue. With wisdom beyond his years, Krugman is both a general skeptic of regional trade agreements and a supporter of NAFTA.

"The Myth of Asia's Miracle" may be the most interesting and important article in this volume. Krugman summarizes the evidence that most growth of output in the Asian tigers has been due to a rapid increase in labor force participation, increased education, and a high saving rate, rather than to a high rate of productivity growth. This was also characteristic of the Soviet Union during its period of rapid growth. "If there is a secret to Asian growth," Krugman concludes, "it is simply deferred gratification, the willingness to sacrifice current satisfaction for future gain."

For too long, there seemed to be a negative relation between an economist's writing ability and the quality of his analysis. Galbraith, Heilbroner, and Thurow, for example, are more widely read than most Nobel laureates. Krugman is one of the few exceptions to this pattern, a creative writer and a brilliant analyst. He is not always right (see my review of his *Peddling Prosperity* in the *Cato Journal*, Vol. 14, No. 2), and he can be as arrogant when he is wrong as when he is right. The only hesitant note in this book is a concern that other people may have taken Krugman's own exposition of strategic trade theory too seriously. For the issues addressed in this book, however, Krugman is right where all too many others, including some economists, are wrong.

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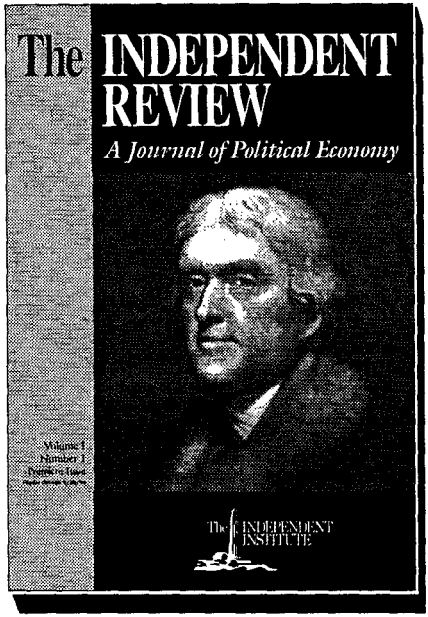

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—Gary S. Becker

Gary Becker in Prague. Edited by Ján Pavlík (Prague: Centre for Liberal Studies, 1996), 69, 75.

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